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SUMMING IT UP

Complying with New IRS Tangible Property Rules

Should you capitalize or expense amounts paid to acquire, produce, or improve Tangible Property?

If you plan to acquire, produce, or improve tangible property, you need to be aware of a recent major overhaul of the IRS regulations regarding which costs can be expensed and which must be capitalized.

After years of wrangling over the issue – often in the courts – the IRS issued regulations in December 2011 that are effective for tax years beginning on or after January 1, 2012. These regulations are both temporary and proposed. This means that while the rules are not final, they are binding on taxpayers.

While the IRS has suspended audit activity in the tangible assets area for two years, it will likely be an area of high audit activity starting in 2014. This gives taxpayers less than two years to make sure they are in compliance with these complex – and still evolving – rules. The final regulations are expected to contain additional changes.

We have highlighted the major changes introduced by the temporary regulations. We will also continue to update our clients and friends about further developments in this area of intense controversy and debate.

SUMMARY:

Prepare for Change

- Acquiring or producing property
- De Minimis rule
- Improving property
- Unit of property
- Building systems
- Routine maintenance
- Rotable and temporary spare parts
- Leased property
- Disposing of property
- Retiring structural components
- General asset accounts
- Materials and supplies
- Accounting method changes

Acquiring or Producing Property

While the temporary regulations retain the rule that costs to acquire or produce tangible property must be capitalized, they also clarify rules regarding costs to facilitate an acquisition, including a special rule for acquisitions of real estate.

A new de minimis rule allows a current deduction for certain amounts to acquire tangible property – as long as the taxpayer meets certain requirements.

Action Step: Taxpayers must review their prior tax treatment of property acquisitions, including costs to investigate and facilitate such acquisitions, and identify any accounting method changes that may be required to comply with the new rules by 2014.

Improving Property

The decision regarding whether to expense or capitalize property improvements is dependent upon the definition of unit of property (UOP), which the IRS has clarified. For example, a building and each building system (e.g., electrical, plumbing, HVAC) are now a separate UOP.

The rules generally retain earlier guidance (from the prior proposed regulations) regarding what constitutes an improvement – which must be capitalized – and a repair – which can be immediately deducted. However the IRS has modified the safe harbor provision for routine maintenance. Expenditures on rotable and temporary spare parts qualify for safe harbor, but buildings and their structural components do not. The rules also provide guidance for both tenants and owners of leased property.

Action Step: Taxpayers must review their prior tax treatment of expensed repairs and capitalized improvements and identify any accounting method changes that may be required to comply with the new rules by 2014.

Disposing of Property

The new regulations allow the recognition of a loss on the retirement of a structural component of a building, such as a roof or HVAC system. Another change provides more flexibility regarding the use of general asset accounts.

Action Step: The ability to claim a deduction for the remaining tax basis of retired structural components, such as a roof that has been replaced, is a clear benefit of the new regulations. However, taxpayers will need to determine the remaining tax basis of the retired structural components, many of which were not accounted for separately. Alternatively, taxpayers can make a late general asset account election for each building to avoid having to write-off retired structural components.

Materials and Supplies

In addition to expanding and clarifying the definition of materials and supplies and adding an optional accounting method for rotable and temporary spare parts, the IRS provides an election to treat certain materials and supplies as de minimis or as depreciable property.

Action Step: Taxpayers must review their prior tax treatment of materials and supplies, including the optional method for rotable and temporary spare parts, and identify any accounting method changes that may be necessary, to comply with the new rules by 2014.

What's the good news for taxpayers?

- De Minimis expensing rule
- Routine maintenance safe harbor
- Deducting retired structural components
- Deducting incidental materials & supplies
- Deducting certain investigation & acquisition costs
- Automatic accounting method changes
- Late general asset account elections

Next Step

This alert only touches on the highlights of these comprehensive regulations. Taxpayers should consult with their tax advisors as soon as possible to determine how these regulations will affect their accounting methods for tangible property.

These changes could result in the need to file an Application for Change in Accounting Method (Form 3115) and adjust the amount of depreciation claimed on certain assets through a section 481(a) adjustment for the 2012 or 2013 tax year. The good news is that the IRS is giving automatic consent to make accounting method changes to comply with these rules. There also may be opportunities to increase cash flow by taking advantage of safe harbor provisions and expensing items that were previously capitalized.

Freed Maxick CapX℠ Services

1. Consultation regarding the following:
    - Change in accounting methods for materials and supplies
    - Change in accounting methods for temporary or rotable spare parts
    - Change in the definition of a unit of property
    - Improvements to tangible property
    - Routine maintenance safe harbor
    - Facilitative costs
    - Dispositions of tangible property
    - General Asset Account and Multiple Asset Account elections
    - De Minimis safe harbor election
2. Identify previously capitalized costs that may be deductible
3. Identify previously deducted costs that may require capitalization
4. Identify changes in accounting methods
5. Prepare tax forms 3115 to report a change accounting method(s) and the related 481(a) adjustment(s)
6. Prepare a report summarizing the results of our review
7. Assist with updating fixed asset records for accounting method changes

Freed Maxick has years of experience helping clients through Cost Segregation studies and the decision regarding whether to expense or capitalize property. We can help you comply with the new IRS regulations and optimize your company's tax position going forward. Please contact us to learn more about Freed Maxick CapX℠ Services.

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