Tax Changes Coming: Tangible Asset Repairs Regulations

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On September 13, 2013 the IRS finally issued long-anticipated legislation regarding tangible assets and repairs. The regulations have been in proposed format for a couple of years and were set to be effective January 1, 2014 whether final regulations were issued or not. In the eleventh hour, the IRS released the final regulations and we can now begin the process of preparing for the upcoming changes.

What's New?

The regulations provide a model for how we must differentiate between capital expenditures and deductible expenses. There are four main areas and nineteen key changes that will affect the method of accounting for many taxpayers. Should any one of these areas affect your business, you may be required to file Form 3115—Change of Accounting Method, with the IRS to be in compliance with the new laws. The four main areas are:

1. Materials and supplies
2. Costs to acquire or produce tangible property
3. Costs to improve tangible property
4. Dispositions

Taking a closer look, here is how the changes may impact you:

The IRS anticipates the majority of taxpayers to be affected and expects to see Changes of Accounting Method requests from most taxpayers.

Materials & Supplies

The regulations distinguish between incidental and non-incidental materials and supplies. Incidental supplies are generally used and consumed without any record of inventory or consumption. These costs are always deductible when incurred. Examples of incidental supplies are pens and paper used in an office.

Non-incidental materials and supplies (for example, blades for a piece of equipment) have a few different treatment options dependent upon the circumstances. If the costs of non-incidental materials fall below the $200 threshold they may be deducted as incurred. If costs exceed $200, the materials must be listed as an asset on the balance sheet and may be expensed only when used or consumed.

A taxpayer may be able to expense the cost if they meet de minimus rule requirements. Taxpayers with an audited financial statement, written capitalization policy and consistent tax treatment, may expense costs not exceeding $5,000 per invoice or item. Taxpayers without an audited financial statement may elect to rely on the de minimus safe harbor and expense items not exceeding a $500 per invoice or per item limit. This is an annual election, which must be made on a timely filed tax return.

Costs to Acquire or Produce Tangible Property

With the exception of materials and supplies, which are deductible under the new materials and supplies definitions, taxpayers must capitalize all amounts paid in conjunction with the production or acquisition of tangible property. In essence, all costs associated with the production or acquisition of tangible property incurred prior to the placed-in-service date must be capitalized. This may include legal or professional fees associated with the activity. Internal costs, such as employee compensation, do not need to be capitalized and investigatory costs incurred to make a determination on an acquisition generally do not have to be capitalized.

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Costs to Improve Tangible Property

A major change in the regulations is the definition of a unit of property (UOP). A UOP is any component which is functionally interdependent. A building and its systems (HVAC units, plumbing, electrical, escalators, etc.) may initially be listed as a single asset. While these building systems may be included with the building for depreciation purposes, the improvement of each building system must be treated as an improvement to that type of property, not a building improvement. A unit of property, building or otherwise, maintains its identity through functional interdependence. For example, an HVAC unit is a different unit of property than the building. The repair regulations provide a three-step test to determine if costs to repair a UOP are repairs or if they classify as improvements which would need to be capitalized. If the costs do not fall into any of these categories, they may be expensed in the year incurred. The categories are:

1. Betterment: a material addition to a UOP or an improvement resulting in an increase in capacity
2. Restoration: a repair resulting in the replacement of a component which has a realized loss or replaces or repairs a part(s) that is a substantial structural part of the UOP
3. Adaptation: the conversion of a UOP to a new or different use

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All costs associated with an improvement must be capitalized and include repair and removal costs. The regulations include a safe harbor for small businesses, which allows them to elect not to apply the improvement regulations. The requirements to qualify as a small business state that the cost of the building must be less than $1 million, the repair is less than either $10,000 or 2 percent of the basis, and the taxpayer's gross receipts are $10 million or less. In order to qualify a taxpayer must meet all three requirements.

Dispositions

The primary change in the regulations for dispositions is related to components of property. Taxpayers must recognize the gain or loss on components as they are disposed. This is particularly impactful to buildings. Often taxpayers replace a roof or building component and while they list the new asset on their depreciation schedule, they continue to depreciate the initial component as a part of the building. The new regulations require that the initial component be carved out of the building cost and that it be disposed of at that time. If taxpayers would rather not take the time and resources to determine costs and components, a General Asset Account election may be made on their upcoming tax return. This election groups assets together and allows for them to be disposed of all at once rather than requiring components to be disposed of as replaced.

The new regulations are lengthy and can be cumbersome. The IRS anticipates the majority of taxpayers to be affected and expects to see Changes of Accounting Method requests from most taxpayers. A change in accounting method may induce an income adjustment on the tax return as well. If you believe you will be impacted by these new regulations, as most taxpayers are, contact a tax professional to help you adopt the new regulations. CG