

TANGIBLE PROPERTY REGULATIONS

TROISIÈME PARTIE

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Jeff McGowan, CPA, CGMA
Tax Partner

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1. **Cover Slide**
2. **Legislative History of Tangible Property Regulations (TPRs)**
 - a. IRS and Treasury Department released various regulations affecting:
 - i. Treatment of materials and supplies,
 - ii. Capitalization of amounts paid to acquire or produce tangible property, and
 - iii. Capitalization and deduction of expenditures relating to repair or improvement of tangible property
 - b. August 18, 2006- Proposed regulations issued
 - c. March 7, 2008- Re-proposed regulations issued
 - d. Dec. 23, 2011 (**CFO SUMMIT 2012**) - Temporary and proposed regulations issued
 - e. Sept. 13, 2013 (**CFO SUMMIT 2013**) - Final and new proposed regulations issued
3. **AGAIN? C'MON! You Promised!! ...But Since We Last Parted**
 - a. January 2014: Rev. Proc. 2014-16 published - accounting method change procedures for final tangible property regulations (TPRs)
 - b. February 2014: Rev. Proc. 2014-17 published - accounting method change procedures for dispositions of tangible depreciable property (proposed regulations)
 - c. August 2014: Disposition of MACRS Property Final Regulations-ALLOW BENEFICIAL WRITE-OFFS
 - d. September 2014: Rev. Proc. 2014-54 published – accounting method change procedures for final regulations on dispositions of tangible depreciable property- MUST DO IN 2014 OR OPPORTUNITY LOST
4. **Final TPRs Review–Summary (not really!)**
 - a. Applicable to amounts paid or incurred in taxable years beginning on or after January 1, 2014
 - i. Early adoption available for amounts paid or incurred in taxable years beginning on or after January 1, 2012
5. **Materials & Supplies**
 - a. A unit of property (UoP) costing \$200 or less
 - b. UoP with an economic useful life of 12 months or less
 - c. Component to maintain, repair or improve a UoP, including rotatable, temporary and standby emergency spare parts
 - d. Fuel, lubricants, water, etc. reasonably expected to be consumed in 12 months or less
6. **Materials & Supplies (cont'd)**
 - a. Types and Timing
 - i. Incidental – deductible when paid or incurred
 - ii. Non-incidental – deductible when first consumed/used (**Method Change #186** to be discussed later)
 - iii. Rotatable, and temporary spare parts – deductible when disposed (optional method available)

7. De Minimis Safe Harbor Election

Taxpayers with Applicable Financial Statements (AFS)	Taxpayers w/o Applicable Financial Statements (AFS)
Written book capitalization policy (based on a specified amount or useful life of 12 months or less) in place at beginning of the tax year	Accounting procedures (based on a specified amount or useful life of 12 months or less) in place at beginning of tax year
Must expense amounts in AFS according to the policy	Must expense in books and records according to the accounting procedure
Amount paid for UoP must be \$5,000 or less per invoice (or per item as substantiated on the invoice)	Amount paid for UoP must be \$500 or less per invoice (or per item as substantiated on the invoice)
Does not apply to: (1) land; (2) inventory; (3) rotatable, temporary or emergency spare parts that taxpayer has elected to capitalize; or (4) rotatables and temporary spare parts for which taxpayer uses the optional method	Does not apply to: (1) land; (2) inventory; (3) rotatable, temporary or emergency spare parts that taxpayer has elected to capitalize; or (4) rotatables and temporary spare parts for which taxpayer uses optional method
ANNUAL ELECTION REQUIRED beginning on/after 1.1.14 Early adoption to 1.1.12 allowed	ANNUAL ELECTION REQUIRED beginning on/after 1.1.14 Early adoption to 1.1.12 allowed
Amounts over the safe harbor amount may be allowed (clear reflection of income)	Amounts over safe harbor amount may be allowed (clear reflection of income)

8. Key Questions To Ask & Action Steps - Materials & Supplies

- a. Determine if M&S are *not* expensed as de minimis expenses
- b. Review balance sheet accounts for M&S not expensed
- c. If M&S are not expensed as de minimis expenses:
 - i. Determine when they are expensed for book and tax
 - ii. Do you keep an inventory of the M&S?
 - iii. Are any of the M&S rotatable, temporary, or emergency spare parts?
 1. If so, determine when and how spare part costs are recovered
- d. Recommend changes to timing of deductions of M&S
- e. Election to capitalize and depreciate materials and supplies is permitted only for rotatable, temporary, or standby emergency spare parts
- f. Determine if method change is required to alter timing of deductions for M&S or spare parts
- g. Accounting method changes, generally, are filed with a modified cut-off sec. 481(a) adjustment

9. Unit of Property (UoP) Comparison – Buildings

Gas Distribution	HVAC	Escalators
Electrical	Structural Components	Fire Protection
Elevators	Plumbing	Security Systems

10. Unit of Property Common Examples of Building System Components

Building Structure	Roof, walls, floors, ceilings, foundation
Heating, Ventilation, & Air (HVAC)	Motors, compress., boilers, furnace, chillers, pipes, ducts, radiators
Plumbing Systems	Pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equip., water utility equip.
Electrical Systems	Wiring outlets, junctions, lighting fixtures and connectors, elec. utility equip.
All Elevators	Elevator boxes, control equipment, cables and movement equipment
All Escalators	Rails, steps, supporting equipment, controls
Fire Protection and Alarm Systems	Sensing & detection devices, computer controls, sprinkler heads & mains, piping & plumbing, alarms, control panels, signage
Security Systems to Protect Building and Occupants	Window & door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarms, entry access
Gas Dist. System	Pipes, gas utility equipment

11. Additional Unit of Property Considerations

- a. UoP (Plant Property)
 - i. Functionally interdependent machinery or
 - ii. Equipment performing industrial process
 - iii. Further broken up to smaller units that perform a discrete and major function
- b. UoP (Leased Property)
 - i. Lessee applies general rules applicable to type of property
 - ii. UoP cannot be > than leased portion of item
 - iii. Lessor applies general rules to each building and its components

12. Capitalization Standards: Improvements to Property (“BAR” current deduction) Betterment Adaption Restoration

13. Betterment

- a. Must capitalize expenditure if:
 - i. Corrects material defects
 - ii. Material addition (physical enlargement, expansion, extension or addition of a major component or space)
 - iii. Reasonably expected to materially increase strength, productivity, efficiency, quality, or output of the UoP

14. Adaption

- a. Capitalize amounts paid for adapting a UoP to a new or different use
 - i. New or different use – inconsistent with intended use of UoP when originally placed in service

15. Restoration

- a. Replacement of a component of a UoP
 - i. Taxpayer has properly deducted a loss other than a casualty loss
 1. Does not apply if loss is attributable only to remaining salvage value
 - ii. Taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss from sale or exchange
- b. Restoration of damage to a UoP for which taxpayer is required to adjust basis as a result of a casualty (casualty loss rule)

16. Restoration (cont’d)

- a. Returning UoP to its ordinarily efficient operating condition if property has deteriorated to a state of disrepair and is no longer functional for its intended use
- b. Rebuilding of a UoP to a like-new condition after end of its ADS class life
- c. Replacement of a part or a combination of parts that comprises a major component (or significant portion of a major component for building property) or substantial structural part

17. Routine Maintenance Safe Harbor

- a. Routine and recurring amounts paid to keep a UoP in ordinary efficient working condition may be treated as repair costs

18. Building/Non-Building Property

- a. Non-building property – must reasonably expect to perform activity more than once during UoPs ADS class life (e.g. 9 years for distributive trades & services)
- b. Building property (structural components or building systems) – must reasonably expect to perform activity more than once during 10-year period beginning with placed in service date (of structure or system, as applicable)

19. Safe Harbor Applications

- a. Only applies to amounts otherwise capitalized under certain restoration provisions
- b. Does not apply to rotatable spare parts accounted for under optional method

20. Safe Harbor Considerations

- a. Consider recurring nature of activity, taxpayer’s experience, manufacturer recommendations, and industry practice

- b. Use of safe harbor constitutes a method of accounting -#184

21. 2014 Reboot/Reset

- a. 2014 is a Critical Year for TPRs

22. Use It or Lose It

- a. Effective January 2, 2014, "Use It or Lose it" is back in force in IRS exams
- b. New Regulation 1.1016-3
 - i. A taxpayer is not permitted to take advantage in a later year of the taxpayer's prior failure to take any such allowance or the taxpayer's taking an allowance plainly inadequate under the known facts in prior years
- c. Applies to Repair & Maintenance items that never should have been capitalized now using the "new" TPR rules as of 1.1.14

23. Form 3115 Filing #1: Recommendation

- a. File one Form 3115 for changes #184, #186, #192
 - i. Mandatory to elect standards just reviewed
 - 1. "reset" (reboot) to final TPR regulations
 - ii. Give opportunity to deduct items currently capitalized under old rules, when reviewed under "new" TPR rules (BAR) should have been expensed
 - 1. BAR & routine maintenance safe harbor criteria
 - 2. Tax only change, Books can remain under "old" method
 - iii. Deduction = IRC Sec. 481(a) negative (favorable) amount
 - iv. Still file even if no deduction taken (no 481(a))

24. Form 3115-Must Do - Method changes #184, 186, 192

- a. See graphic on slide 24 for details

25. Form 3115 Excerpts

- a. See graphic on slide 25 for details

26. Example of #184 Change-Betterment/Restoration Analysis

- a. ROOF MEMBRANE - PLANT #1 placed in service 2008; depreciated over 39.5 years, Cost \$4,396 (A/D=\$531)
- b. Facts of capitalized asset
 - i. Roof in factory building is comprised of structural elements, insulation, and waterproof membrane.
 - ii. Waterproof membrane began to wear with leakages
 - iii. Taxpayer replaces roof membrane with similar but new membrane (thus, not a betterment)
 - iv. Although roof membrane may effect function of building structure, it is not major component or substantial structural part of building structure
- c. Negative 481(a) adjustment = \$3,865 write-off

27. Example of #184 Change- Restoration Analysis

- a. Office building with one HVAC System - comprised of three furnaces, three AC units, and duct work throughout the building
- b. Furnace breaks down, replaced with a new furnace, cost \$9,695 in 2013 depreciated over 39 years (A/D = \$342)
- c. The three furnaces together perform a critical function in operation of HVAC system.
- d. However replacing a single furnace is not a significant portion of this major component of the HVAC System.
- e. Not a restoration of the UOP (HVAC system)
- f. Negative 481(a) adjustment (favorable) of \$9,353

28. #184 Attachment to 3115 Example

- a. See graphic on slide 28 for details

29. Comparing Capitalized Restorations vs. Repairs & Maintenance

- a. Examples of items capitalized that must remain capitalized (CAP) vs. allowed as Repair & Maintenance (R&M) (#184) by failing new TPR "Restoration" principles include:
 - i. Restoration in a state of disrepair

- 1. Farm buildings — to shore up walls and replace siding [CAP]
- ii. Rebuild to like-new before end of class life
 - 1. Railroad cars, ADS 14 — rebuilds every 8 to 10 years [#184], but [CAP] if done in 15th year
- iii. Replacement of major component
 - 1. Replace engine and cab [CAP]
 - 2. Replace one furnace out of 3 furnaces and 3 AC units [#184]
 - 3. Replace the only chiller in a building [CAP]
 - 4. New wiring throughout the building [CAP],
 - 5. 30% of all wiring [#184]

30. Other #184 Write-off Possibilities Where Previously Capitalized

- a. Deemed R&M Examples
 - i. Replacement of 30% of HVAC units does not involve a significant portion of the major component (all HVAC units) or a large portion of the physical structure of the unit (the HVAC system).
 - ii. Replacement of 40% of the sinks in a building does not involve a significant portion of the major component (all the sinks) or a large portion of the physical structure of the unit (the plumbing system).
 - iii. Replacement of 25% of the elevators in a building does not involve a significant portion of a major component (as each elevator does not perform a discrete and critical function) or a large portion of the physical structure of the unit (the elevator system).
- b. Deemed Capitalizeable Item
 - i. Replacement of 40% of the floors in a building does involve replacement of a significant portion of the major component (all the floors).
- c. Regs "Rule of Thumb" Example Implications
 - i. < 33 1/3% unit of property replacement considered R&M
 - ii. >33 1/3% but < 40% - ??????????????????????????????????????
 - iii. >40% capitalize

31. Method Change #186 & #192...along for the ride

- a. Final #186
 - i. Deducting non-incidentals materials or supplies when used or consumed
 - 1. If not been previously treating so, must now do for 2014 and beyond
 - a. Usually no 481(a) adjustment
 - 2. If have been treating this way, affirming that will continue
- b. Final #192
 - i. Capitalizing and depreciating acquisition or production costs
 - 1. If not been previously treating so, must now do for 2014 and beyond
 - a. Usually no 481(a) adjustment
 - 2. If have been treating this way, affirming that will continue

32. TPRs 2014 (and beyond) Overhaul For Asset Dispositions

33. Major OVERALL Changes in the Disposition Rules in TPRs. WHY??

- a. Since 1981: "Must add as a new depreciable item building systems or structural components and cannot write off the old disposed part."
- b. New Rules: Taxpayers have choice to write off old
 - i. Prior year "partial" asset dispositions (PAD)-#196
 - 1. Must file 3115 by 2014 or lose that opportunity
- c. Current year "partial" asset dispositions & elections for each and every future year disposition(s)

34. Form 3115 Filing #2

- a. File **another** separate Form 3115 change #196
- b. ("Late" Prior-Year Asset Dispositions) = Deductions for dispositions or partial dispositions occurring in prior tax year but basis still depreciating (Pre-2014 dispositions)
 - i. 2014 only opportunity to write-off duplicate assets
 - ii. For long-lived assets with remaining basis as of December 31, 2013
 - 1. e.g. Roofs, leasehold improvements, land improvements, paving

35. Identification and Basis of Asset Disposed Under #196 Change

- a. Facts and circumstances of each disposition are considered in determining appropriate disposed asset
- b. Examples of reasonable methods include the following:
 - i. Discounting cost of the replacement asset to its placed-in service year cost using the **Producer Price Index for Finished Goods**
 1. **PPI ROLLBACK**
 - ii. Pro rata allocation
 - iii. Study allocating the cost of asset to its individual components
 1. **COST-SEGREGATION**
- c. Use of PPI rollback method is **not** possible if the new asset(s) deemed a betterment and/or adaption (and not a restoration)
 - i. PPI rollback can only be used on Capitalized Restorations (R)
- d. Not due by 2014 but if a taxpayer doesn't want to have to capitalize removal costs, it must file this method change

36. Example of #196 Change Late Prior-Year Asset Disposition

- a. Essenhau, Inc. purchased a building in Aug. of 2002 for \$7,500,000 and replaced 60% of its roof in April of 2012 for \$500,000
 - i. Improvement falls under Restoration Capitalization
- b. Essenhau, Inc. capitalized the new roof and makes a late PAD election using a PPI rollback
- c. Essenhau must calculate basis of the roof disposed of, and accumulated depreciation in order to calculate negative 481(a) adjustment in 2014

37. Example of #196 Change Late PAD (cont'd)

- a. PPI from April 2012 is 194.9 and for Aug 2002 was 138.8
- b. Doing the PPI rollback of \$500,000 computes as follows:
 - i. $(\$500,000 * 138.8) / 194.9 = \$356,080$
 - ii. Accumulated depreciation up to 12.31.13 = \$104,230 (approx)
- c. IRC 481(a) negative adj. = $\$(251,850)$ [356,080 - 104,230]
- d. Reduce basis of original building down by \$356,080 cost and related accumulated depreciation
- e. IMPORTANT NOTE: PPI discount method not allowed for betterment or adaptation dispositions

38. Optional/Beneficial Filings – Form 3115 Filing #3

- a. File Form 3115 for #21 removal costs - can do post 2014
- b. Enables a taxpayer not to have to capitalize any prior or future removal costs associated with an improvement (i.e., R.A.B)
- c. Only can be done if have made #196 change for PAD (Partial Asset Dispositions)
 - i. Current/prior years allowed
 - ii. Evidence for removal costs for prior years difficult
- d. Removal costs=costs incurred for removing asset or component are not required to be capitalized
- e. Future/prior bills from contractors to break out removal costs to allow possible deductions?

39. Removal Costs §1.263(a)-3(g) — Example 3

- a. Component removed during R&M, no disposition
 - i. XYZ uses a building in its business
 - ii. Over time the shingle roof leaks but it is still functioning
 - iii. XYZ replaces the old shingles with new comparable shingles
 - iv. XYZ "disposes" of the old shingles but does not elect partial asset treatment in the year of disposition
 1. The replacement "disposal" of the shingles is a R&M
- b. RESULT-XYZ does not have to capitalize the shingle removal costs as they directly benefit and are incurred by the R&M

40. Removal Costs §1.263(a)-3(g) — Example 4

- a. Same facts, except XYZ disposes of the original shingles and elects treatment under 8(d)(2) and deducts the adjusted basis of the original shingles as a loss

- i. As XYZ deducted a loss, the new shingles are a restoration
- ii. XYZ is required to capitalize amounts paid for the replacement of shingles
- b. RESULT: XYZ is not required to capitalize the removal costs

41. Optional/Beneficial Filings (no 3115 required)

- a. Partial Disposition Election- Form 4797 (current dispositions)
 - i. Filing 4797 = election to make partial disposition of an asset
 - ii. Claim loss on disposed portion of structural component of building without identifying component as asset before disposition event (break out "old" asset part of larger asset)
 - iii. Election must be made on a partial disposition using Form 4797 on a timely filed return "including extensions" in taxable year in which disposition occurs (2014 or later years)
 - iv. Not mandatory, but cannot go back and amend if not done on original filing in disposition year
- b. Election to capitalize repair and maintenance costs
 - i. Keeps book/tax conformity
 - ii. New TPR rules are "use it or lose it" under RAB

42. Other Considerations (MANY!)

- a. Form 3115 to fix Impermissible to Permissible Depreciable Method Change #7
 - i. Can file for 2014/if not may face "use it or lose it"
 - ii. Fix class lives and take bonus amounts not previously taken
- b. TPR elections, not made on Forms 3115, must be made annually
- c. Small Taxpayers Safe Harbor
 - i. Applies to taxpayers with 3-year average gross receipts not > \$10M
 - ii. Applies to owned/leased buildings with unadjusted basis not > \$1M
 - iii. Total amount paid during tax year for repairs, maintenance, and improvements cannot exceed lesser of:
 - 1. 2% of the unadjusted basis of the building, or
 - 2. \$10,000
- d. BDO 4 page summary Attachment D

43. Benefits of TPR Compliance

- a. Opportunity to deduct repair and/or disposition costs
 - i. Large tax savings opportunity
 - ii. 2014 only year for #196
 - iii. "Use it or Lose it" under exam
- b. Optimal amount and timing of deductions
- c. Reduced IRS exam issues
 - i. Higher audit risk for taxpayers not filing Form 3115s in 2014
- d. No tax return disclosures (8275/8275R Disclosure)
- e. Tax return process simplified by including needed elections and method changes

44. Risks of Non-Compliance

- a. Tax return preparer may be unable to sign the 2014 tax return without attaching the Form 8275-R Disclosure for non-compliance with regulations
 - i. No materiality threshold for Circular 230—if a CPA signs and files a federal tax return for 2014 for a TP without addressing the TPR issues (i.e., filing necessary 3115s or certain election statements), the CPA could be in violation of Circular 230 and subject to disciplinary action
- b. POTENTIAL LARGE LOST TAX \$\$\$\$

45. Closing Thoughts

- a. 2014 (tax year beg. 1.1.14) critical year for examining depreciation schedules to review items with remaining depreciable basis as of 12.31.13 (prior fiscal year end) that should have been expensed or can be disposed of
 - i. #184 changes, items capitalized, that under BAR rules/Routine Maintenance, can be expensed
 - ii. #196 (2014 only!!!) to dispose of duplicate assets, normally new addition where offsetting asset "buried" within prior large capitalization amount
- b. As CPAs we are bound by Circular 230 to File 3115s and this will be an added expense for 2014 tax returns!!
- c. Goal: Tax Savings > Cost of Compliance