SEILER LLP
CERTIFIED PUBLIC ACCOUNTANTS

TAX ALERT

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The New Tangible Property Regulations Are Final!

If your business buys, creates or improves tangible property, the way you capitalize or deduct those costs has changed.

The IRS started revising the regulations for how businesses treat tangible property costs several years ago, and the regulations are now final. The final regulations retain many of the provisions found in the temporary regulations from 2011, but they also simplify those regulations and add new safe harbor provisions that will help you more easily identify expense deductions.

Who does this impact?
All businesses

When does this take effect?
Fiscal years starting January 1, 2014 or later

What do I need to know?
The regulations are lengthy (over 60 pages long) and complex, meaning you will probably need to walk through these matters with your accountant to understand how these fully apply to your business. You will most likely have to file additional IRS forms this year as a result of these new rules. We've summarized the main points of what you need to know below.

Do I need to do anything?
We strongly recommend contacting your tax accountants soon to go over how these final regulations affect your upcoming tax returns.

Summary of Changes
- Capitalization or Deduction
- Unit of Property (UOP)
- Buildings
- Property Other Than Buildings
- Materials and Supplies
- De Minimis Safe Harbor
- Routine Maintenance Safe Harbor
- Per-Building Safe Harbor for Qualifying Small Taxpayers
- Accounting Method Changes
- California Conformity to Tangible Property Regulations

Capitalization or Deduction
The regs set forth the general rule that amounts paid to improve a unit of property must be capitalized. An improvement is defined as an expenditure that:

- betters a unit of property,
- restores it, or
- adapts it to a new and different use.

On the other hand, the regs allow a current deduction for repairs and maintenance to property. Deductible repair and maintenance expenses are defined in a negative way, they are deductible if not otherwise required to be capitalized.

Unit of Property (UOP)
One key concept in the regs is the "unit of property" (UOP) that is being improved or repaired. The smaller the UOP, the more likely it is that costs incurred in connection with it will have to be capitalized. For example, work on an engine of a vehicle is more likely to be classified as an expense that must be capitalized if the engine is classified a separate UOP. By contrast, if the UOP is the vehicle, the engine work has a better chance of passing muster as a repair.

Buildings
When it comes to buildings, the regs generally treat each building and its structural components as one UOP-the "building." The regs also list nine specific building systems that are treated as separate from the building structure. An improvement to the building is defined by its effect on those systems, rather than on the building as a whole.

Property Other Than Buildings
In general, for property other than buildings, a single UOP consists of all components that are functionally interdependent, such that one component can't be placed in service without the other components.

Say that a business buys a battery-powered golf cart for its foreman to use in getting around a large warehouse. It buys the chassis from one vendor and the battery from another, and then assembles the two components. Here, the cart is the UOP, since the chassis can't be placed in service without the battery.

Materials and Supplies
A deduction is allowed for amounts paid to produce and acquire materials and supplies that are consumed during the year. Materials and supplies are defined to include five specific categories of property used or consumed in the business operations.

UOPs with an economic useful life of no more than 12 months qualify as materials and supplies under this rule. Likewise, certain inexpensive items qualify as materials and supplies. Under the final regs, this rule applies to UOPs that cost $200 or less to acquire or produce

De Minimis Safe Harbor

The regs allow a taxpayer to deduct certain limited amounts paid for tangible property that are expensed for financial accounting purposes. Under the 2011 temporary regs, this de minimis safe harbor was only available to taxpayers that had an applicable financial statement (AFS), which can be a certified audited financial statement used for credit purposes, reporting to partners, or other non-tax purposes. The final regs change this by allowing businesses without an AFS to use the de minimis safe harbor.

A taxpayer with an AFS may rely on the de minimis safe harbor if no more than $5,000 per invoice, or per item as substantiated by the invoice, was paid for the property. For businesses without an AFS, the maximum figure is $500 rather than $5,000.

To use the safe harbor, the business must have accounting procedures in place at the beginning of the tax year that treat as an expense amounts paid for property that costs less than a specified dollar amount or has an economic useful life of 12 months or less. It is important to note that maximum figures are the safe harbor amounts and facts and circumstances may allow for the use of higher amounts in formulating capitalization policies. We can assist you in making sure that your business meets these requirements.

Routine Maintenance Safe Harbor

The regs include a safe harbor that allows certain expenses of routine maintenance to be deducted rather than capitalized. Routine maintenance means recurring activities that keep business property in ordinarily efficient operating condition, such as:

- inspection,
- cleaning,
- testing, and
- replacement of damaged or worn parts.

For a building structure or system, the taxpayer must reasonably expect to perform the maintenance more than once during the 10-year period that begins when the structure or system is placed in service. For property other than buildings, the taxpayer must reasonably expect to perform the activities more than once during the property's class life for depreciation purposes.

Per-Building Safe Harbor for Qualifying Small Taxpayers

The final regs add a new safe harbor that allows qualifying small taxpayers-those with average annual gross receipts of $10 million or less in the three preceding tax years-to deduct improvements made to a building property with an unadjusted basis of $1 million or less. This safe harbor applies only if the total amount paid during the tax year for repairs, maintenance, and improvements to the building doesn't exceed the lesser of $10,000 or 2% of the building's unadjusted basis.

This safe harbor may be elected annually on a building-by-building basis. It is elected by including a statement on the tax return for the year the costs are incurred for the building. We can help you to take advantage of this rule by filing the necessary election.

Accounting Method Changes

A change to conform to the regs is considered a change in accounting method, for which additional forms and accounting adjustments may be required. The IRS has issued procedures under which taxpayers can get automatic consent to the accounting method change.

California Conformity to Tangible Property Regulations

California partially conforms to these new regs. For personal income tax purposes (individuals, partnerships, and LLCs taxed as partnerships) and for S corporations, California generally conforms to the new regs.

However, for C corporations California conforms to the regs regarding business expense deduction for repairs, but does not conform to MACRS and has never conformed to ACRS. Generally, C corporations do not conform to the new regs relating to capitalizing improvements.

Next Steps

Again, we strongly recommend reaching out to your tax accountant as soon as possible to begin planning. If you have any questions, please feel free to contact us at (650) 365-4646 or email info@seiler.com. We would be happy to discuss appropriate courses of action for your business.

About Seiler LLP

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