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MARKS PANETH TAX ALERT: IRS ISSUES SWEEPING RULES THAT AFFECT BUSINESSES OWNING TANGIBLE PROPERTY

The IRS has released its final regulations on the tax treatment of expenditures related to tangible property. The regulations provide guidance on how to comply with Sections 162 and 263 of the Internal Revenue Code, which require the capitalization of amounts paid to acquire, produce or improve tangible property but allow amounts for incidental repairs and maintenance of property to be deducted. The regulations explain how to distinguish between capital expenditures and deductible business expenses.

The regulations (IRS T.D. 9636) generally will apply to tax years beginning on or after Jan. 1, 2014. They affect all businesses that own or lease tangible property, including buildings, machinery, vehicles, furniture and equipment.

Background

The new regulations have been under development for years. In 2006, the IRS released the first set of proposed regulations, which were subsequently withdrawn. The IRS released another set of proposed regulations in 2008, which never took effect.

In December 2011, temporary regulations were released that provided a general framework for capitalization. The final regulations replace those temporary regulations but retain many of their provisions. In addition, they modify several sections and create a number of new safe harbors.

Amounts paid to improve property

A cost that results in an improvement to a building structure or to any of the enumerated building systems (for example, the plumbing or electrical system) must be capitalized. An improvement occurs if there was a betterment, restoration or adaptation of a unit of property. The final regulations make some significant changes and additions to the temporary regulations regarding improvements, including:

Routine maintenance safe harbor. An activity isn't considered an improvement if the taxpayer expected to perform it as a result of its use of the property or to keep the property in its ordinarily efficient operating condition. The activity is considered routine if, at the time the property was placed in service, the taxpayer reasonably expected to perform the activity more than once during the property's life.

The temporary regulations limited the safe harbor to tangible property "other than buildings," but the final regulations extend it to buildings. The taxpayer must reasonably expect to perform the building-related activities more than once in 10 years. The regulations make several additional changes and clarifications to the routine maintenance safe harbor, applicable to both buildings and other property.

Amounts incurred for activities outside the safe harbor don't necessarily have to be capitalized, though. These amounts are subject to analysis under the general rules for improvements.

New safe harbor for small businesses. The regulations add a safe harbor for qualified small business taxpayers (generally, those with gross receipts of $10 million or less). For buildings that initially cost $1 million or less, taxpayers may elect to deduct the lesser of $10,000 or 2% of the adjusted basis of the property for repairs, maintenance, improvements and similar activity each year.

Betterment test. The final regulations address the temporary regulations' test for determining whether an amount paid "results in" betterment. They no longer phrase the test in terms of amounts that "result in" betterment. Rather, they provide that a taxpayer must capitalize amounts reasonably expected to

materially increase the productivity, efficiency, strength, quality or output of a unit of property or that are a material addition to a unit of property.

Restoration test. An amount paid for the replacement of a major component or substantial structural part of a unit of property is an amount paid to restore that property. The final regulations include a new definition for use in determining whether an amount spent on replacement constitutes a restoration.

They provide that an amount is for the replacement of a major component or substantial structural part if the replacement includes a part or combination of parts that comprises 1) a major component or a significant portion of the building structure or any building system, or 2) a large portion of the physical structure of the building or any building system.

Materials and supplies

The final regulations retain many of the 2011 rules regarding materials and supplies, but they increase the dollar threshold for property that's exempt from capitalization from $100 to $200. The regulations also keep the temporary rule allowing taxpayers to make an election to capitalize certain materials and supplies but limit it to rotable, temporary or standby emergency spare parts. Taxpayers can revoke this election by filing a ruling request.

The final regulations clarify the optional method in the temporary regulations, which allowed taxpayers to treat the rotable and temporary spare parts as used or consumed in the year of disposition or elect to treat them as depreciable assets. Taxpayers are no longer required to use the method for all pools of rotable spare parts used in that trade or business — they can opt not to use the method for those pools for which they don't use the optional method on their books and records.

The de minimis rule for expensing

The temporary regulations provided that a taxpayer who expensed the purchase price of tangible property for financial reporting purposes — according to written accounting procedures for expensing those amounts — on an applicable financial statement could deduct the amount for tax purposes, up to an aggregate ceiling. The ceiling was set at the greater of 0.1% of the gross receipts for the tax year for income tax purposes or 2% of the total depreciation and amortization expense for the tax year. For this purpose, an applicable financial statement generally is a certified audited financial statement or one required to be submitted to a federal or state government or agency.

The final regulations replace the ceiling with a new safe harbor determined at the invoice or item level. A taxpayer with an applicable financial statement now can apply the de minimis rule to deduct all amounts properly expensed as long as the amount paid for property doesn't exceed $5,000 per invoice or per item.

The final regulations allow taxpayers who are members of a consolidated group for financial statement purposes — but not federal income tax purposes — to use the group's applicable financial statements and written accounting procedures to qualify for the de minimis safe harbor.

The regulations also expand the de minimis rule to encompass amounts paid for property having a useful economic life of 12 months or less as long as the amount per invoice (or item) doesn't exceed $5,000. They add a de minimis rule for taxpayers without applicable financial statements, as well.

In addition, the final regulations provide that the de minimis rule is an irrevocable elective safe harbor, not mandatory. If elected, it must be applied to all amounts paid in the taxable year for tangible property that meets the requirements, including amounts paid for materials and supplies.

The final regulations require that the de minimis safe harbor be applied to *all* eligible materials and supplies if elected. The temporary regulations allowed taxpayers to select materials and supplies for application of the rule.

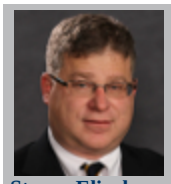
Going forward

If you have expenditures related to tangible property, the final regulations apply to you. Compliance may require changes to your current capitalization procedures and the filing of Form 3115, “Application for Change in Accounting Method.” If you have questions regarding the final regulations and how to best proceed, we’d be happy to help.

TAX PLANNING GUIDE

To facilitate ongoing access to the latest tax rules and regulations, Marks Paneth offers an online tax guide that is updated on an ongoing basis.

FOR MORE INFORMATION



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If you have questions about anything you read in this alert or in our tax guide, please contact a Marks Paneth tax advisor or Steven Eliach, JD, LLM, the Principal-in-Charge of the Marks Paneth Tax Practice, by phone at 212.503.6388 or by email at seliach@markspaneth.com.