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Tax Info flash

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Final Regulations on the Capitalization of Tangible Property Issued

The IRS and Treasury recently issued final tangible property capitalization regulations. The final regulations attempt to bring clarity to a complicated area of tax law. Many taxpayers own tangible property that they maintain and repair. Taxpayers may keep spare parts on hand in case the property breaks down, and in some cases, a taxpayer may improve the property. The final regulations address the proper characterization and tax treatment of expenditures related to these maintenance, repair, and improvement activities.

Below is a brief overview of some of the significant provisions of the final regulations that differ from the provisions of the temporary regulations (issued in 2011) they replace and remove. Taxpayers may choose to continue to apply the 2011 temporary regulations to tax years beginning on or after January 1, 2012, and before January 1, 2014. Please note that these regulations do not finalize temporary regulations addressing the definition of “disposition” for depreciable property. Revised regulations that address that issue were proposed concurrently with the final regulations.

Background

Section 263(a) of the Code generally requires the capitalization of amounts paid to acquire, produce, or improve tangible property. On the other hand, taxpayers are allowed to deduct ordinary and necessary business expenses, including the costs of certain supplies, repairs, and maintenance under §162(a). It is not always easy to distinguish between an asset that must be capitalized and property that is a material or supply used in a trade or business. The line between improvement and repairs or maintenance is not always clear.

Former regulations attempted to define the difference between capital and non-capital expenditures by providing that capital expenditures included amounts paid or incurred to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or adapt the property to a new or different use. Those regulations also provided that amounts paid or incurred for incidental repairs and maintenance of property were not capital expenditures. These standards were subjective and required a fact-intensive analysis of the taxpayer's situation. Not surprisingly, there has been considerable controversy between taxpayers and the IRS over the proper characterization of these expenses.

The unveiling of these final tangible property capitalization regulations is the culmination of a multi-year effort involving intermediate guidance and taxpayer feedback. With a number of clarifications and new safe harbors, the final regulations represent a collaborative effort between taxpayers and the IRS to bring a degree of certainty to an area of tax law traditionally fraught with controversy. The final regulations are generally effective for tax years beginning on or after January 1, 2014.

Materials and Supplies

Expanded Definition: The final regulations expand somewhat the definition of "material and supplies" set forth in the 2011 temporary regulations by increasing the $100 ceiling for characterizing a unit of property as a material or supply to $200. Taxpayers had expressed concern that the $100 amount would not capture many common supplies, like calculators or coffee makers. With the $200 amount, the IRS attempts to balance concerns over distortions to income that could result from increasing the acquisition cost ceiling with the need to include the typical materials and supplies ordinarily used by many taxpayers. Like the temporary regulations, the final regulations give the IRS authority to change the amount of this threshold between deductible costs and expenses that must be capitalized, and to identify specific items as material and supplies, through published guidance.

Election to Capitalize: Another difference between the 2011 temporary regulations and the final regulations is the optional election to capitalize certain materials and supplies instead of deducting their cost in the first year they are used or consumed. As presented in the temporary regulations, the requirement to elect to capitalize material and supply costs was inconsistent with prior revenue rulings that distinguished certain rotable, temporary, and standby emergency spare parts from materials and supplies and permitted taxpayers to treat that property as depreciable assets. The final regulations characterize rotable, temporary, or standby emergency spare parts as materials and supplies and modify the election so that it is available only for these parts.

Optional Method of Accounting for Rotable and Temporary Parts: A final point of note is the removal in the final regulations of the requirement that the optional method of accounting for rotable and temporary spare parts, if elected, be used for all of a taxpayer's rotable and temporary spare parts in the same trade or business. Recognizing that taxpayers may have pools of rotable or temporary parts that are treated differently for financial statement purposes, the final regulations provide that a taxpayer generally is not required to use the optional method for those pools for which it does not use the optional method of accounting in its books and records. However, if a taxpayer chooses to use the optional method for any pool for which the taxpayer does not use the optional method in its books and records, then the taxpayer must use the optional method for all its pools of rotable and temporary spare parts in that trade or business.

De Minimis Safe Harbor

Both the temporary and final regulations provide a general rule that transaction costs associated with acquiring or producing a unit of property must be capitalized. Both regulations also provide a de minimis exception to the rule. The final regulations make significant changes to the de minimis rule, a few of which are described here.

The de minimis exception, as provided in the temporary regulations, allowed a taxpayer to deduct certain amounts paid for tangible property if the taxpayer had an applicable financial statement, had appropriate written accounting procedures for expensing certain amounts and treated those amounts as expenses on its applicable financial statement. The deduction was limited to a ceiling that could only be calculated after the end of a tax year. While the ceiling itself could be calculated relatively simply, the financial accounting systems employed by most taxpayers would not allow them to easily determine which costs the de minimis rule applied to and, therefore, whether or not applicable costs exceeded the ceiling.

Taxpayers With an Applicable Financial Statement: To both address taxpayers' concerns and ensure that the de minimis safe harbor in the final regulations requires taxpayers to use a reasonable, consistent methodology clearly reflecting income for tax purposes, the ceiling was replaced in the final regulations with a new safe harbor determined at the invoice or item level and based on the policies that the taxpayer utilizes for its financial accounting books and records. A taxpayer with an applicable financial statement

may rely on the de minimis safe harbor of the final regulations only if the amount paid for property does not exceed $5,000 per invoice, or per item as substantiated by the invoice.

The revised de minimis safe harbor also applies to a financial accounting procedure that expenses amounts paid for property with an economic useful life of 12 months or less as long as the amount per invoice or item does not exceed $5,000. If the cost exceeds $5,000 per invoice or item, then the amounts paid for the property will not fall within the de minimis safe harbor.

Taxpayers Without an Applicable Financial Statement: An additional modification of the de minimis safe harbor in the final regulations is an expansion to include taxpayers without an applicable financial statement, but who have accounting procedures in place to deduct amounts paid for property costing less than a specified dollar amount or amounts paid for property with an economic useful life of 12 months or less. The de minimis safe harbor for taxpayers without an applicable financial statement provides a reduced per invoice (or item) threshold because there is less assurance that the accounting procedures clearly reflect income. A taxpayer without an applicable financial statement may rely on the de minimis safe harbor only if the amount paid for property does not exceed $500 per invoice, or per item as substantiated by the invoice. If the cost exceeds $500 per invoice or item, then no portion of the cost of the property will fall within the de minimis safe harbor.

Application to All Eligible Materials and Supplies: Another significant change to the de minimis safe harbor is that taxpayers are not permitted, as they were under the temporary regulations, to select materials and supplies to be expensed under the de minimis rule. Rather, the final regulations require that the safe harbor be applied to all eligible materials and supplies (other than rotable, temporary, and standby emergency spare parts subject to the election to capitalize, or rotable and temporary spare parts subject to the optional method of accounting) if the taxpayer elects the de minimis safe harbor.

Amounts Paid to Acquire or Produce Tangible Property

The 2011 temporary regulations provided that a taxpayer usually must capitalize amounts paid to facilitate the acquisition or production of real or personal property, and in an effort to alleviate controversy between taxpayers and the IRS, the temporary regulations included a list of inherently facilitative amounts. Additional rules regarding these inherently facilitative amounts were included. Among them were special rules for inherently facilitative amounts allocable to real or personal property that ultimately was not acquired.

The final regulations generally retain the rules from the temporary regulations addressing facilitative amounts. As in the temporary regulations, the final regulations include a special rule for the acquisition of real property providing that, except for amounts specifically identified as inherently facilitative, an amount paid by a taxpayer in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire. The final regulations do not expand the deduction of pre-decisional, investigatory costs to personal property because, unlike real property acquisitions, personal property acquisitions do not typically raise issues of whether the transaction costs should be characterized as deductible business expansion costs rather than costs to acquire a specific property.

In addition, the final regulations retain the rule that inherently facilitative amounts allocable to real or personal property are capital expenditures related to the property, even if the property is not eventually acquired or produced. The final regulations also clarify that, except for contingency fees, inherently facilitative amounts allocable to property not acquired may be allocated to that property and recovered in accordance with the applicable provisions of the Code.

Routine Maintenance and Improvements to Property

The final regulations include a host of changes and clarifications to the rules for determining whether an amount improves, betters, or restores property. This letter highlights a few of the more significant changes pertaining to buildings, a new safe harbor for small taxpayers, and determining whether a betterment has occurred.

Unit of Property: One issue addressed in the final regulations is whether a building, together with its various components, is a single unit of property. The 2011 temporary regulations generally defined a building as a unit of property, but required the application of the improvement standards to the building structure and the enumerated building systems. The final regulations retain the unit of property rules contained in the 2011 temporary regulations. Accordingly, if an amount paid results in a restoration of a building structure, such as the replacement of an entire roof, then the expenditure constitutes an improvement to the building unit of property. Similarly, if an amount paid results in a betterment to a building system, such as an improvement to the HVAC system, then the expenditure also constitutes an improvement to the building unit of property.

Removal Costs: Another issue addressed in the final regulations is the treatment of removal costs. The 2011 temporary regulations did not provide a separate rule for the treatment of removal costs. Instead, the temporary regulations addressed component removal costs as an example of a type of indirect cost that must be capitalized if the removal costs directly benefit or were incurred by reason of an improvement. The final regulations provide that, if a taxpayer disposes of a depreciable asset for tax purposes, and has taken into account the adjusted basis of the asset or component of the asset in realizing gain or loss, the costs of removing the asset or component are not required to be capitalized under §263(a). The final regulations also provide that if a taxpayer disposes of a component of a unit of property and the disposal is not a disposition for tax purposes, then the taxpayer must deduct or capitalize the costs of removing the component based on whether the removal costs directly benefit or are incurred by reason of a repair to the unit of property or an improvement to the unit of property.

Small Taxpayer Safe Harbor: A new safe harbor was added in the final regulations, to aid small taxpayers applying the general rules for improvements to buildings, because small taxpayers generally do not have the administrative means or sufficient documentation or information to apply the improvement rules to their building structures and systems. The safe harbor election applies to building property held by taxpayers with gross receipts of $10,000,000 or less ("a qualifying small taxpayer"). The final regulations permit a qualifying small taxpayer to elect to not apply the improvement rules to an eligible building property if the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of $10,000 or 2% of the unadjusted basis of the building. Eligible building property includes a building unit of property that is owned or leased by the qualifying taxpayer, provided the unadjusted basis of the building unit of property is $1,000,000 or less.

Routine Maintenance: The temporary regulations provided that the costs of performing certain routine maintenance activities for property other than a building or the structural components of a building are not required to be capitalized as an improvement. Under this routine maintenance safe harbor, an amount paid was deemed not to improve a unit of property if it was for the recurring activities that a taxpayer (or a lessor) expected to perform as a result of the taxpayer's (or the lessee's) use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Activities were routine only if, at the time the unit of property was placed in service, the taxpayer reasonably expected to perform the activities more than once during the property's alternative depreciation system class life (regardless of whether the property was depreciated under the alternative depreciation system). The safe harbor did not apply to building property, because the 40-year class life could allow major remodeling or restoration projects to be deducted under the safe harbor, regardless of the nature or extent of the work involved.

The final regulations contain a safe harbor for routine maintenance for buildings. The inclusion of a routine maintenance safe harbor for buildings is expected to alleviate some of the difficulties that could arise in applying the improvement standards for certain restorations to building structures and building systems. The final regulations use 10 years as the period of time in which a taxpayer must reasonably expect to perform the relevant activities more than once. The IRS chose the 10-year period because of concern that use of a longer period would permit the inappropriate deduction of many major remodeling and restoration projects.

The final regulations make a number of additional changes and clarifications to the safe harbor for routine maintenance, which are applicable to both buildings and other property. Among these clarifications is the provision that amounts incurred for activities falling outside the routine maintenance safe harbor are not necessarily expenditures required to be capitalized. Amounts incurred for activities that do not meet the routine maintenance safe harbor are subject to analysis under the general rules for improvements.

***Betterments*:** The rules pertaining to betterments are among those changed by the final regulations. The 2011 temporary regulations defined when an amount paid results in a betterment, and accordingly, an improvement, to buildings and other property. Among other changes to the betterment rules, the final regulations reorganize and clarify the types of activities that constitute betterments to property. In an effort to reduce controversy for expenditures that span more than one tax year or when the outcome of the expenditure is uncertain when the expenditure is made, the final regulations also change the betterment test so that it no longer is stated in terms of amounts that “result in” a betterment. Instead, the final regulations provide that a taxpayer must capitalize amounts that are reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of a unit of property or that are for a material addition to a unit of property.

Election to Capitalize Repair and Maintenance Costs

The 2011 temporary regulations did not contain an election for taxpayers to capitalize expenditures made with respect to tangible property that would otherwise be deductible. In recognition of the significant administrative burden reduction achieved by permitting a taxpayer to follow for tax purposes the capitalization policies used for its books and records, the final regulations permit a taxpayer to elect to treat amounts paid for repair and maintenance of tangible property as amounts paid to improve that property and as an asset subject to the allowance for depreciation, as long as the taxpayer incurs the amounts in carrying on a trade or business and the taxpayer treats the amounts as capital expenditures on its books and records used for regularly computing income.

A taxpayer that elects this treatment must apply the election to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that tax year. A taxpayer making the election must begin to depreciate the cost of the improvements when the improvements are placed in service by the taxpayer under the applicable provisions of the Code and regulations. Once made, the election may not be revoked.

A taxpayer that capitalizes repair and maintenance costs under the election is still eligible to apply the de minimis safe harbor, the safe harbor for small taxpayers, and the routine maintenance safe harbor to repair and maintenance costs that are not treated as capital expenditures on its books and records.

Applicability Dates

The final regulations generally apply to tax years beginning on or after January 1, 2014. A taxpayer may choose to apply the 2011 temporary regulations to tax years beginning on or after January 1, 2012, and before January 1, 2014.

Capitalization is a complex area of tax law, but an area that is critically important to many taxpayers. The final regulations are a step in the direction of clarity. However the transition to and application of the new rules is certain to remain a complicated matter. As always, please call us (562) 463-3818 if you have any questions or would like to discuss these topics further.

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