What You Need to Know About the Final Tangible Property Regulations

Whether to take a deduction or capitalize and depreciate expenditures related to tangible property has been in question for a number of years. Tangible property includes personal property such as materials, supplies, machinery, equipment, furniture, and leasehold improvements, as well as real property like land, buildings and other structures. The IRS issued Revenue Procedure 2015-20, commonly known as the final Tangible Property Regulations (TPRs) on February 13, 2105 to clarify how amounts paid to acquire or improve tangible property must be treated for tax purposes, as well as materials and supplies.

Unit of Property

The TPRs are based on a new concept called the unit of property (UoP). The determination as to whether an expense has to be capitalized or deducted is based on the UoP that it is associated with and the classification of the expense. A building and its structural components (walls, floors, ceiling, windows, doors, etc.) is considered one UoP. Each building system (HVAC, plumbing, electric, escalators, elevators, fire protection and alarm systems, security systems, gas distribution systems, etc.) and functionally independent machinery or equipment are considered a separate UoPs.

Acquisition Costs

The amount paid or incurred to acquire or produce tangible property must be capitalized. This includes the transaction costs associated with the acquisition such as shipping fees, moving costs, appraisals, valuations, application fees, bidding costs, permits, broker fees, legal fees, other professional service fees, etc.

Improvement Costs

The regulations require the capitalization of an expenditure if it is classified as a betterment, adaptation or restoration of a UoP. A betterment is defined as a correction of a material defect, material addition (physical enlargement, expansion, extension or addition of a major component or space) or material increase in the strength, productivity, efficiency, quality or output of the UoP. An adaptation is a change in the use of the tangible property and restoration is the replacement of a major component of a UoP or returning the UoP to its original condition.

Material and Supplies

Materials and supplies are deductible provided that the UoP costs $200 or less, its economic useful life is 12 months or less, or it's a component to maintain, repair or improve a UoP (including temporary or standby emergency spare parts). In addition, items that are expected to be consumed in 12 months or less such as water, fuel, and lubricants are considered materials and supplies. The IRS has specific guidelines on other items that qualify as material and supplies.

Change in Accounting Methods

The TPRs are effective for tax years beginning on or after January 1, 2014. Even so, the new regulations give businesses the opportunity to go back and adjust the accounting method used for tangible property so it is in compliance with the TPRs for tax years beginning after January 1, 2012. This opportunity is only available to taxpayers in 2014.

Interested parties must file an Application for a Change in Accounting Method (Form 3115) with the IRS on their income tax return, as well as directly with the IRS office in Ogden, Utah. All changes in accounting methods to adopt the TPRs in prior tax years qualify as an automatic change request which eliminates the need to obtain prior approval from the IRS. Certain multiple accounting changes can be included on one Form 3115. However, there are circumstances where more than one Form 3115 will have to be filed.

Making a change in accounting method can be advantageous. Taxpayers may be able to take tax deductions for amounts previously capitalized that may now be an expense under the TPRs. For example, if a company made a repair to its roof in 2010 and determined that the expense should be capitalized and depreciated over 39 years, it can now deduct the remaining undepreciated cost of the roof repair in the current year. Under the TPRs the roof repair is not considered a restoration, betterment, or an improvement to the property. Instead, it is considered maintenance which is deductible.

Taxpayers should be aware that failure to calculate the impact of a change in accounting method based on the TPRs may result in the loss of current and future tax depreciation or the potential write-off of previously capitalized expenses.

Taxpayer Friendly Provisions

The TPRs have several provisions that are taxpayer friendly. The **partial disposition election** gives taxpayers the ability to take a deduction for the replacement of components of building assets such as a roof, HVAC unit or flooring that were originally capitalized.

The **"de minimis" safe harbor election** allows taxpayers to deduct amounts paid to acquire or produce tangible property that are expensed for financial accounting purposes or in keeping the company's books and records. Businesses with Applicable Financial Statements (certified audited financial statements, SEC or regulatory filing) can expense amounts paid up to $5,000 per invoice or item. Taxpayers without Applicable Financial Statements that have the proper accounting procedures in place in the beginning of the tax year can expense up to $500 per invoice or item.

Taxpayers can adapt a **routine maintenance safe harbor** to expense the cost of cleaning, testing, inspecting and replacing worn components provided the activities are done more than once during the asset's depreciable life or within 10 years for buildings and their systems.

Qualifying small businesses (annual gross receipts of $10 million or less in three proceeding tax years) can take the **small taxpayer safe harbor** election to deduct repair, maintenance and improvement expenses on eligible buildings (owned or leased with an unadjusted basis of $1 million or less). The total amount paid during the tax year cannot exceed the lesser of $10,000 or 2% of the unadjusted basis of an eligible building. This safe harbor can be elected annually on a building-by-building basis.

There is a lot of information in the public domain on these new regulations. One good reference is the AICPA's Quick Summary of the Tangible Property Regulations which provides guidance to taxpayers and explains important terms. Nevertheless, the TPRs are very complex and it is advisable to consult with your tax advisor before implementing any change.

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