ACCOUNTING

Deconstructing the final tangible property regulations

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For years, the U.S. Internal Revenue Service (IRS) and taxpayers disputed whether certain expenditures were required to be capitalized and depreciated or be immediately written off as repair and maintenance expenses.

For expenditures related to residential or commercial buildings, the tax consequences between taking an immediate deduction versus capitalization and depreciation over a lengthy 27.5 or 39 years are staggering. In 2004, the IRS began drafting new rules to address this conflict and, after several iterations, yielded the final Tangible Property Regulations (TPR).

When the TPRs became fully effective for the 2014 tax year, CPAs and tax professionals scrambled to understand and implement the new rules. These regulations affect most businesses and many individual taxpayers. The TPRs apply to expenditures related to fixed assets and clarify rules applicable to the deductibility of materials, supplies and parts. They provide important new guidance on dispositions as well as optional elections that may yield tax savings. The TPRs may also impact previous years' capitalized assets, which would then require filing IRS Form 3115, Application for Change in Accounting Method.

In response to public concerns, the IRS issued Rev. Proc. 2015-20 as relief for small businesses. Rev. Proc. 2015-20 provides a simplified method of compliance for small business taxpayers (i.e., less than $10 million in assets or less than $10 million in average annual gross receipts) to change a method of accounting under the final TPRs on a prospective basis for the first taxable year beginning on or after Jan. 1, 2014. The IRS waived the requirement to complete and file Form 3115 for small business taxpayers that choose to use this simplified procedure. However, election statements are still required for the de minimis safe harbor and the small taxpayer safe harbor on a prospective basis.

For others not meeting the criteria of a small business, the implementation of the TPRs is a challenge that led many taxpayers to file extensions for 2014. Even though compliance with the TPRs can be time consuming, in many cases it can offer tremendous opportunities to claim faster tax deductions for various expenditures that were capitalized in prior years, even for those meeting the Rev. Proc. 2015-20 definition of a small business taxpayer. Below is a list of considerations under these new rules.

DE MINIMIS SAFE HARBOR

A new rule allows taxpayers to immediately deduct certain small-dollar expenditures that may have required capitalization under previous tax rules. This safe harbor allows taxpayers with *Applicable Financial Statements* (i.e., audited financial statements in most situations) to adopt depreciation policies requiring the immediate write-off of items costing up to $5,000. Taxpayers using this safe harbor must have a written accounting procedure in place as of the beginning of the tax year and consistently follow the policy for both book and tax purposes. For taxpayers without Applicable Financial Statements, the threshold is $500, but a written policy is not necessary. This safe harbor requires a statement attached to a timely filed return.

ROUTINE MAINTENANCE SAFE HARBOR

The final regulations allow a taxpayer to immediately deduct certain building costs if the taxpayer expects to perform the activity more than once within a 10-year period. Examples may include repainting a hotel lobby or replacing an escalator handrail if expected to be performed at least twice within 10 years. An election statement is not necessary.

SMALL TAXPAYER SAFE HARBOR

Taxpayers that meet the definition of a "small taxpayer" and own a building with an unadjusted basis of $1 million or less may be able to make elections that allow them to immediately deduct certain costs that would otherwise require capitalization. For this purpose, a small taxpayer is one whose average annual gross receipts for the three preceding years is $10 million or less. An eligible taxpayer can deduct expenditures up to the lesser of $10,000 or 2 percent of the unadjusted basis of the building. For corporations and partnerships, the election is made by the entity and not the shareholder or partner. ▶

PLANNING POINT: The $1 million building basis limit is only for building real property (not inclusive of land). For buildings over the $1 million threshold, consider a cost segregation study to reclassify personal property and land improvements from the basis of real property. For example, a $1.1 million building will not initially meet the safe harbor's requirements but can qualify with a cost segregation study that reclassifies $200,000 into personal property, whereby the remaining real property basis is less than $1 million and qualify under this safe harbor in all future years.

DEMOLITION COSTS

Under prior law, taxpayers were required to capitalize removal costs into the basis of the replacement asset. Now, taxpayers can immediately deduct such costs as long as they claim a retirement loss deduction on the removed component.

PLANNING POINT: Taxpayers should request that contractors separately state demolition and removal costs on invoices so these expenditures can be immediately deducted (after carefully considering Code Section 280B).

SUPPLIES

The final regulations clarify the definition of supplies and when taxpayers can deduct them. For example, anything that costs less than $200 or is expected to be consumed within 12 months can be treated as a supply and immediately deducted.

RE-CHARACTERIZATION OF PAST EXPENDITURES

The final regulations allow taxpayers to immediately deduct current or previously capitalized expenditures. Examples may include certain building costs such as electrical, plumbing or HVAC unit replacements. Conversely, taxpayers who were overly aggressive in immediately deducting capital expenditures should review their prior year repairs registers as well as their current year capitalization policies. Any corrections should be made in the 2014 tax return by filing IRS Form 3115.

PARTIAL DISPOSITION ELECTION

Prior to the new rules, there was no clear guidance that allowed taxpayers to deduct costs of removed building components, such as an old roof, HVAC systems or windows. The final TPRs allow taxpayers to deduct any undepreciated basis of these removed components even if disposed in prior years, which may yield significant and immediate tax deductions. For example, a taxpayer that replaced a roof in 2010 can now deduct the undepreciated cost of that roof. However, taxpayers are only allowed to write off assets disposed in past years on the return for the tax year beginning Jan. 1, 2014.

PLANNING POINT: It is important to review all prior-year building improvements to determine if there were any partial dispositions of components. If this is not done for the 2014 tax year, the taxpayer must continue to depreciate these assets and forgo the opportunity to immediately write off any undepreciated basis as compliance with this provision may not be permitted future tax years.

NEW IMPROVEMENT RULES

The most significant portion of the TPRs focus on clarifying rules on what can be immediately deducted or must be capitalized. Examples of immediately deductible expenses include the installation of a new roof membrane, replacing three of 10 HVAC units in a building or remediating asbestos. Proper analysis requires careful consideration of the unit of property and of whether the expenditure results in a betterment, adapts the unit of property to a new or different use or results in a restoration. For buildings, each major building system must be analyzed as a unit of property.

RULE OF THUMB: For expenditures that are not considered a betterment or adaptation, the rule of thumb is that replacing one-third or less of a building component will be a repair expense as long as the taxpayer is not required to adjust the basis of the component disposed.

INCREASED IMPORTANCE OF COST SEGREGATION STUDIES

Cost segregation studies accelerate the timing of deductions by reclassifying personal property and land improvements, which have favorable tax attributes, from building costs, which do not. Quality cost segregation studies quantify the costs of removed components, which make it easy for taxpayers to take losses on them. Additionally, they can organize certain building information for proper repair analysis required by the TPRs. For buildings purchased and improved in prior years, a quality cost segregation firm employing TPR experts will analyze the new repair rules and provide information needed to claim missed deductions.

SUGGESTION: Only consider using a cost segregation firm that provides a final schedule clearly showing each building system stipulated by the TPRs along with other building categories that can be expected to be replaced (e.g., windows, doors, roof, lighting, interior finishes, etc.). For multi-tenant commercial buildings, make sure the study breaks out each tenant improvement in a clear schedule allowing the taxpayer to properly claim abandonment loss deductions in future years.

CONCLUSION

Even though the TPRs are extensive and complex, they do offer a number of taxpayer-favorable provisions. With careful implementation of the new regulations, many taxpayers are claiming missed deductions from prior tax years as well as opportunities to accelerate deductions in current and future tax years. ■