New Tangible Property Regulations

APPLY TO: Individual taxpayers who file Schedule C (small business and disregarded LLCs), Schedule E (rental property owners), Schedule F (farmers), as well as all business entities.

Effective for tax years 2014 and forward, new rules dubbed "repair regulations" specify whether expenditures for tangible property may be currently expensed or must be capitalized and depreciated over time. In the good ole days, taxpayers and practitioners chose to distinguish between repairs and improvements depending on whether a purchased asset merely fixed a problem or extended the useful life of the property. For example, the cost to replace a broken window pane could be deducted in full, whereas the cost to install double-paned glass would have to be depreciated. While taxpayers were disappointed that they could not gain an immediate benefit from the expenditure, they were comforted to know that the expense was not "wasted" since the tax reduction was spread over time and the full cost would eventually be recovered.

Alas, the IRS was not content with this relatively simple distinction and has instead implemented rules to "help" taxpayers distinguish between repairs and improvements. As a result, the GENERAL RULE now holds that all tangible property purchased for use in a trade or business – except inventory – must be capitalized, except:

1. Materials and supplies may be expensed if the cost is less than $200 or the item has a useful life of less than 1 year [Treas. Reg. §1.263(a)-3(n)].

2. Costs for routine maintenance which a taxpayer may expect to incur more than once throughout the useful life of an asset to keep the property in its ordinarily operating condition may be expensed under the **Routine Maintenance Safe Harbor** rule [Treas. Reg. §1.263(a)-3(i)].

   changed to $2,500 as per IRS Notice 2015-82

3. Costs up to ~~$500~~ ($5,000 for taxpayers with applicable financial statements) may be expensed by taxpayers who annually, irrevocably and affirmatively make an election as per the **De Minimis Safe Harbor** rule [Treas. Reg. §1.263(a)-1(f)].

4. Costs equal to the greater of 2% of a building's basis or $10,000 if incurred by a small taxpayer with average annual gross receipts under $10 million who owns a building with a basis under $1 million and who annually, irrevocably and affirmatively makes an election as per the **Small Taxpayers with Buildings Safe Harbor** rule [Treas. Reg. §1.263(a)-3(h)].

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All other taxpayers must capitalize expenditures as per the general rule if they result in betterment, restoration or adaptation of property defined as:

- Betterment – costs that result in enlargement, expansion or extension of property or are reasonably expected to increase productivity, efficiency or output
- Restoration – costs that return previously non-functional property to use, rebuild property to like-new condition, repair casualty losses, or replace a major component
- Adaptation – costs that facilitate a new or different use of property

<u>NOTE:</u> Elections under the De Minimis and Small Taxpayers with Buildings Safe Harbor rules [#s 3 and 4 above] must be made annually by attaching a statement to the return. Elections and therefore statements are not required to expense qualified materials, supplies and routine maintenance costs [#s 1 and 2 above]; they are merely recorded as "repairs" on the tax return.

Amazingly, these rules have been placed into effect both prospectively *and* retroactively! That means that taxpayers must review depreciation schedules associated with previously filed returns to determine if repairs and improvements had previously been properly classified. If, for example, expenditure had been depreciated on an earlier return which instead could have instead expensed under the new regulations, the taxpayer may file *Form 3115 Application for Change in Accounting Method* with his current return and reap the benefit of the previously forfeited tax deduction. Of course, the converse is true as well: If a taxpayer previously expensed costs that should have been depreciated, *Form 3115* must be used to make the appropriate adjustment and recognize previously untaxed income.

Sounds simple until you consider that (1) *Form 3115* is an 8 (!) page form plus attachments and explanations, that (2) the taxpayer must be able to compute the now allowable deduction using the prescribed present value analysis, that (3) he must then make an IRC § 481(a) adjustment, and that (4) the resulting tax savings may be subject to passive activity limitations. By filing the form, taxpayers may report a late partial disposition, write-off capitalized assets that could instead have been expensed, and obtain the benefits of audit protection as provided in Rev. Proc. 2015-14 but the costs and inconveniences may be prohibitive. What to do?

Rev. Proc. 2015-20 (just issued on February 13th, 2015) comes to the rescue of "small" business owners by allowing these taxpayers to take advantage of the repair regulations on a prospective basis only without requiring accompanying retroactive adjustments. Thus, taxpayers with assets or average annual gross receipts under $10 million may use what is known as the "cutoff" method whereby assets placed in service prior to 2014 would continue to be accounted for using the old method; assets placed in service in 2014 and beyond would be subject to the new regulations. This simplified method must be applied uniformly to *all* assets.

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REMINDER: Elections are made prospectively; Accounting changes via *Form 3115* are made retroactively. Changes for prior years are not *required* to be made if a taxpayer chooses to implement the simplified procedures outlined in the recently issued Rev. Proc.

Taxpayers should note that some state tax authorities have elected to conform to all federal repair regulations while others offer no conformity or only partial conformity. California, for example, has chosen to conform to the materials and supplies provision but not to the partial asset disposition rules. California conforms to accounting changes filed by individual, trusts, estates, partnerships and S-Corps with the IRS but not to changes filed by corporations.

Monica's Office Policy

Since each taxpayer's situation is unique, no single methodology can be recommended. It is incumbent upon each taxpayer to select the reporting procedure that will yield the greatest benefit to him. In my practice, I will offer a summary review of past depreciation schedules to help my clients determine if further analysis (possibly even a cost segregation study) is warranted.

In general, I have operated on the principle that a capital asset is a unit of property with a useful life exceeding 1 year and an acquisition cost exceeding a few hundred dollars; as a result, such assets have been depreciated rather than expensed. Barring a client's affirmative election to file *Form 3115* to request a retroactive accounting method change, I shall continue to employ my long-standing policy which is consistent with the new regulations. Clients are hereby notified that capitalizing and depreciating assets in accordance with IRS rules may result in a lower deduction in the current year but that the costs of all assets will eventually be recouped; the accounting distinction merely creates a timing difference as to whether the full deduction will be recognized now or later.

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