IRS Revenue Section 263(a) Changes to Asset Classification Under Tangible Property Regulations

Tangible Property Regulations have been in a state of almost constant flux since 2008. On December 23, 2011, the IRS released temporary regulations for Secs. 162(a), 168 and 263(a) regarding expenditures to acquire, improve, and maintain tangible property. Prior to these temporary and proposed regulations, there were several sets of temporary regulations. The 2011 regulations were initially effective for tax years beginning on or after January 1, 2012, but were later amended to tax years beginning on or after January 2014. Additionally, disposition of assets and the losses accounted also have new regulations. This naturally creates some uncertainty over which regulations to apply to a particular tax year, although the IRS has said that taxpayers have an option when it comes to which regulations to apply.

The last several months have created a whirlwind of information and discussion regarding tangible property and repair regulations, after the IRS issued a revised Directive in March. It is expected that there will be significant changes to Section 263(a), known as the “Tangible Property Regulations” before the end of 2013. The result of the temporary regulations has drastically changed the landscape of asset classification, presentation and how items are accounted for from a tax perspective. Any taxpayers that acquire, produce or improve tangible property such as buildings, machinery or equipment, will be affected by the Tangible Property Regulations.

There have been many articles written, some good, but mostly poor, on what this means to taxpayers. In light of the numerous past and proposed future revisions, it’s not easy to determine what the general ramifications are, much less how to apply these new regulations to your individual tax scenario. Educated readers know that if the IRS is involved, companies should never “hope” they are properly applying guidelines, but rather be sure that they are. In this White Paper, we will help you understand and apply some of the regulations.

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As Tangible Property Regulations continue to be refined, it will be important to understand the requirements and what options are available to you, based on your specific situation.

Tangible Property Regulations
and Changes to Asset Reclassification

Key Definitions

In order to begin to clearly understand and apply Tangible Property Regulations, it's important to clarify some of the key definitions that arose out of the new regulations. These are just a few of those terms:

Unit of Property – This concept is used as a basis for determining whether costs are currently deducted as an expense or capitalized and depreciated over a series of years.

Routine Maintenance – Recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the property to keep it in its ordinarily efficient operating condition.

Betterments – A permanent improvement made to increase the value of property and one that must be capitalized.

General Asset Accounts – Taxpayers must elect to recognize a gain or loss on a qualifying disposition of an asset if it is categorized in a general asset account. A general asset account is established and maintained with bases and depreciation for specific assets.

Important Considerations

Here are some important highlights and directly relevant facts that taxpayers should be aware of:

The new *De Minimis* Rules allow certain taxpayers to expense certain costs if they meet the following requirements:

- Have written accounting procedures in place at the beginning of the year for expensing property under a certain dollar amount
- Have an applicable financial statement
- Expense property in bullet point one on the applicable financial statement

If the above is met, taxpayers are allowed to expense items which are less than or equal to:

- 0.1% of the taxpayer's gross receipts for the tax year, or
- 2% of the taxpayer's total depreciation and amortization expense for the tax year

Part of the significant changes applies in the area of dispositions of building structural components. Historically, if a taxpayer replaced a roof, they were required to continue to depreciate the old roof and begin depreciation on the new roof, even though the old roof was disposed of. Essentially, the taxpayer would receive no cost recovery of the old roof when the new roof is placed in service, even though it is gone. The IRS knew they had to correct this flaw in the Code.

Moving forward, assets- if tracked in general asset accounts, may be disposed of and gains or losses captured as appropriate based upon useful life, depreciation and related facts.

Additionally, taxpayers are able to catch up on previously unreported dispositions via a Form 3115. If a taxpayer disposed of long-lived assets, whether it be HVAC, electrical or structural components and never claimed the deduction due to the old rules or because the assets were not broken out on the records of the company, there is now an opportunity to capture all losses for those assets via a 3115 on a current year's return and move forward.

Note: Pursuant to Revenue Procedure 2015-20 issued in February 2015, small business taxpayers are no longer required to file a Form 3115 to change methods of accounting. Small business taxpayers are defined as those with less than $10 million in assets or less than $10 million in annual revenue. Because this definition is disjunctive, some larger businesses may also qualify if they have over $10 million in assets but under $10 million in receipts, or vice versa. The new method established by Revenue Procedure 2015-20 is available on a prospective basis for the tax year beginning on or after January 1, 2014. After 2014 the process is a little bit more tedious.

Deciding whether or not to amend returns or file for a Change in Accounting Method (Form 3115) is entirely dependent upon each taxpayer's situation. A thorough analysis of each taxpayer's scenario by an advisor experienced in §179D is advantageous to determining the best approach and claiming the maximum deduction allowed under the law.

This is a much welcomed alternative to the continuing to write off assets over their remaining useful lives as they are often not broken out or identifiable in the accounting records of the company. Many times, because the tax lives are 27.5 years or 39 years, the vast majority of the tax life still remains at disposition for structural components and there is no way to capture benefit. Fortunately, times have changed.

The other main issue within the latest Tangible Property Regulations involves the question of whether costs of maintaining, replacing or improving tangible property must be capitalized under Sections 263(a) or treated as repair and maintenance costs under Section 262.

Navigating the Changes

Clearly, there is potential for broad tax implications for a wide range of corporate taxpayers. And, with more proposed changes ahead, it is difficult to predict exactly how the regulations will affect taxpayers. The best approach in the meantime is: Detail. Detail. Detail. It's essential to track everything very diligently with descriptions so specific that you can always identify each asset. A significant suggestion is to create an accounting policy to record repairs, improvements and disposition of assets and consistently apply it. Doing the aforementioned will allow for efficient and compliant asset tracking.

As Tangible Property Regulations continue to be refined, it will be important to understand the requirements and what options are available to you, based on your specific situation. This is where having professional guidance and expertise can ensure that the Tangible Property Regulations work for you.

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