

Commonly asked questions on the new tangible property regulations

A compilation of questions and answers from recent webcasts

November 2013

Materials and supplies

Question 1: How is a rotatable defined?

Answer 1: Rotatable spare parts are defined as materials and supplies under Reg. section 1.162-3(c)(1)(i) that are acquired for installation on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation. Temporary spare parts are materials and supplies under Reg. section 1.162-3(c)(1)(i) that are used temporarily until a new or repaired part can be installed and then are removed and stored for later installation (see Reg. section 1.162-3(c)(2)).

De Minimis safe harbor

Question 2: What is an AFS? Does it have to be GAAP-based only, or can it be IFRS? And, does an AFS include audits, reviews and compilations, or just an audit?

Answer 2: For purposes of the de minimis safe harbor in Reg. section 1.263-1(f), a taxpayer's applicable financial statement (AFS) is the taxpayer's financial statement listed in Reg. section 1.263(a)-1(f)(4)(i) through (iii) that has the highest priority. The financial statements are, in descending priority:

- (i) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);
- (ii) A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for:
 - (A) Credit purposes;
 - (B) Reporting to shareholders, partners or similar persons; or
 - (C) Any other substantial non-tax purpose; or
- (iii) A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the IRS).

An AFS can be prepared based on IFRS as long as it meets the definition of one of the financial statements described in (i) – (iii), above. However, a reviewed or compiled financial statement will not be considered an AFS since a review or compilation does not involve the

provision of a certified audited financial statement. See the AICPA's [What Is the Difference Between a Compilation, a Review and an Audit? Comparative Overview](#).

Question 3: We have an AFS book capitalization policy of \$10,000 that we have followed for tax for many years, through exam. How are we affected by the new \$5,000 safe harbor?

Answer 3: Pursuant to Reg. section 1.263(a)-1(f), for a taxpayer with an AFS, the safe harbor only applies to items with a cost of \$5,000 or less. However, the preamble to the final regulations specifically states that the de minimis safe harbor is "not intended to prevent a taxpayer from reaching an agreement with its IRS examining agents that, as an administrative matter, based on risk analysis or materiality, the IRS examining agents will not review certain items. It is not intended that examining agents must now revise their materiality thresholds in accordance with the de minimis safe harbor limitations provided in the final regulation. Thus, if examining agents and a taxpayer agree that certain amounts in excess of the de minimis safe harbor limitations are not material or otherwise should not be subject to review, that agreement should be respected, notwithstanding the requirements of the de minimis safe harbor. However, a taxpayer that seeks a deduction for amounts in excess of the amount allowed by the safe harbor has the burden of showing that such treatment clearly reflects income."

Therefore, it is still possible that your tax treatment will continue to be allowed. However, you will have the burden of showing that the treatment of items costing more than \$5,000 is appropriate. Additionally, it should be noted that despite your current book-tax policy exceeding the \$5,000 safe harbor amount, you could still elect to use the safe harbor for items costing \$5,000 or less. This way, you will have the safe harbor protection for such items and will only have the burden of showing that the treatment of items costing more than \$5,000 is appropriate (if the safe harbor is not elected, it may not be relied on for any amounts deducted under the de minimis book-tax policy).

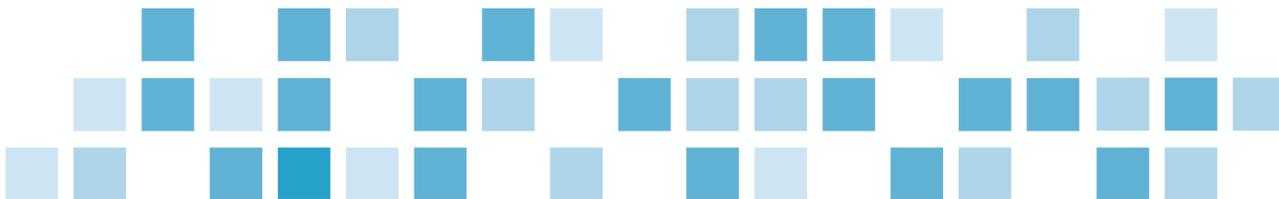
Question 4: If our current capitalization policy for accounting purposes is \$2,000, would we be required to analyze all expenses over \$2,000 to determine if they are required to be capitalized for tax purposes since our limit is less than the \$5,000 de minimis safe harbor?

Answer 4: Under the de minimis safe harbor, the tax treatment must follow the written book policy (but is limited to items costing up to the threshold amounts). Thus, if the written policy is to expense any item costing \$2,000 or less for book purposes, a taxpayer with an AFS would only be able to include items costing \$2,000 or less in the de minimis safe harbor deduction for tax purposes as well, assuming the taxpayer meets the other requirements of the safe harbor (see Reg. section 1.263(a)-2(f)). Accordingly, any item costing more than \$2,000 would need to be analyzed to determine whether it constitutes a material and supply under Reg. section 1.162-3(a), an amount paid to acquire or produce a unit of property under Reg. section 1.263(a)-2(d)(1), or an amount paid to improve a unit of property under Reg. section 1.263(a)-3(d).

Question 5: What company policy should be in writing by January 1, 2014.

Answer 5: In order for a taxpayer to use the de minimis safe harbor election for a tax year, as of the beginning of such tax year, a taxpayer with an AFS must have written accounting procedures (or in the case of a taxpayer without an AFS, accounting procedures) treating as an expense for non-tax purposes:

- (1) Amounts paid for property costing less than a specified dollar amount, or



- (2) Amounts paid for property with an economic useful life (as defined in Reg. section 1.162-3(c)(3)) of 12 months or less

See Reg. section 1.263(a)-1(f)(3)(vi) for rules specific to groups of entities that have one written procedure for the group.

Additionally, the taxpayer must meet other requirements in order to be eligible for the safe harbor election. Reg. section 1.263(a)-1(f) provides the rules and guidance with respect to qualifying for and electing the de minimis safe harbor.

Improvements

Question 6: For the small business taxpayer safe harbor, how do you define gross receipts? Are proceeds from the sale of fixed assets included?

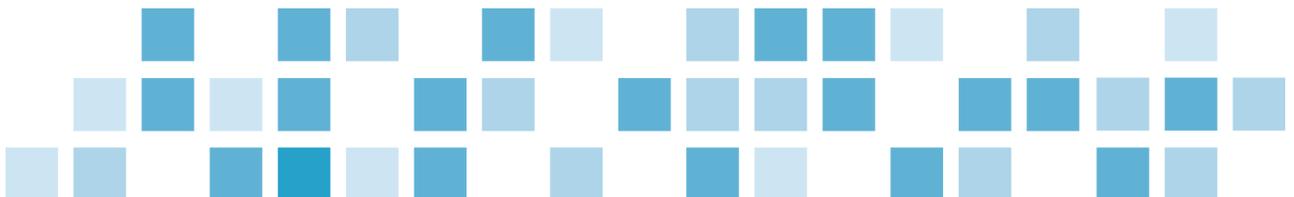
Answer 6: Reg. section 1.263(a)-3(h)(3)(iv) defines gross receipts (for purposes of determining whether a taxpayer is a qualifying taxpayer for purposes of the small taxpayer safe harbor) as follows:

“[T]he term *gross receipts* means the taxpayer’s receipts for the taxable year that are properly recognized under the taxpayer’s methods of accounting used for Federal income tax purposes for the taxable year. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer’s trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221(a)(1), (3), (4), or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in section 1221(a)(2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer’s adjusted basis in such property.” (emphasis added)

The regulation goes on to define specific items that are not included in gross receipts, and states that:

“Gross receipts do not include the repayment of a loan or similar instrument (for example, a repayment of the principal amount of a loan held by a commercial lender) and, except to the extent of gain recognized, do not include gross receipts derived from a non-recognition transaction, such as a section 1031 exchange. Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.”

Question 7: Under the small business safe harbor, the qualifying taxpayer for the three prior years must have average gross receipts of less than or equal to \$10 million. Is the \$10 million an annual average amount or a cumulative amount?



Answer 7: For purposes of the small taxpayer safe harbor, the \$10 million is the average annual gross receipts for the prior three taxable years. So, for instance, if a calendar-year taxpayer is making the determination of whether it's a qualifying taxpayer for purposes of the small business safe harbor for its 2014 tax year, it will generally look to the average of its annual gross receipts for its 2013, 2012 and 2011 tax years. Assume the gross receipts for the taxpayer are as follows:

2011 - \$7 million
2012 - \$9 million
2013 - \$11 million

For 2014, the taxpayer will be considered a qualifying taxpayer for this purpose as its average annual gross receipts for the prior three years are \$9 million (total of \$27 million divided by 3). This is true even though its gross receipts for 2013 were over \$10 million.

See Reg. section 1.263(a)-3(h) for the rules applicable to the small taxpayer safe harbor and for guidance specific to short taxable years and/or new taxpayers.

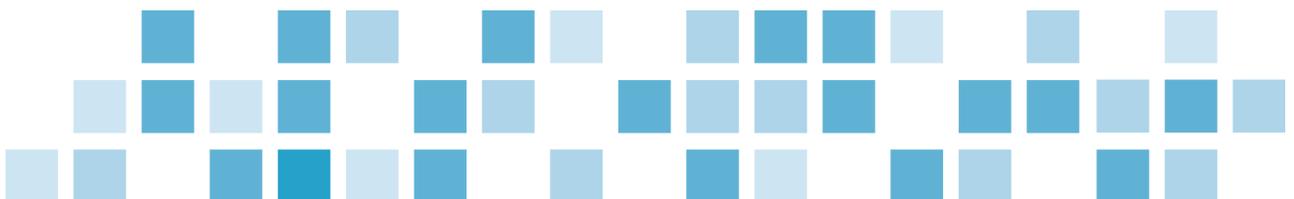
Question 8: In regards to repairs made to building structures, does book treatment need to be the same as the tax treatment? In other words, can you expense a repair for tax purposes but capitalize the repair for book purposes?

Answer 8: The tax treatment of repair or improvement costs is not tied to book treatment. Although there are several areas where the government has provided elections in an effort to reduce book-tax differences if a taxpayer desires (e.g., the election to capitalize repair costs in accordance with book treatment or the de minimis safe harbor election), taxpayers are not required to use the same method for determining improvement versus repair costs for book and tax purposes. Subject to the elections provided in the final regulations, taxpayers should follow the improvement rules provided in Reg. section 1.263(a)-3 in determining the costs that should be capitalized as improvement costs for tax purposes. This is also true for the small taxpayer safe harbor. If a taxpayer qualifies and properly elects the safe harbor to an eligible building, it must not treat any costs incurred to repair or improve the eligible building as improvement costs under Reg. section 1.263(a)-3, regardless of how it treats such costs for book purposes.

Question 9: Does the cost of a new roof of \$20,000 have to be capitalized?

Answer 9: The answer depends on how much of the roof is being replaced and whether it is being "repaired" with the same or comparable parts versus improved parts that (1) could result in a material addition or increase in capacity of the building structure, or (2) are reasonably expected to materially increase the productivity, efficiency, strength, quality or output of the building structure (see Reg. section 1.263(a)-3(j)(3), example 13). Additionally, it should be determined whether the replacement of the (portion) of the roof should be treated as the replacement of a major component (or significant portion of a major component) or a large portion of the building structure (see Reg. section 1.263(a)-3(k)(6)(ii) for a discussion of major components in the context of buildings; see also Reg. section 1.263(a)-3(k)(7), examples 14 and 15, which specifically address replacements of roofs and components of roofs).

Question 10: I want to clarify the repair and maintenance rule. I'm in the Real Estate business and have several buildings. If the escalator breaks down and needs to be repaired, do I have to capitalize the cost if it's more than the amount eligible for exclusion under the de minimis safe harbor?



Answer 10: The answer depends on whether or not the activity undertaken with respect to the escalator results in an improvement to the building unit of property under the improvement rules of Reg. section 1.263(a)-3. Although a building is one unit of property, the improvement analysis must be done on a building-system-by-building-system basis. Reg. section 1.263(a)-3(e)(2) provides a list of each building system and states that all escalators are considered to be one building system. Thus, you'll need to determine whether the activity undertaken results in a betterment, restoration or adaptation to a new or different use of all of the escalators in the building (see Reg. section 1.263(a)-3(j) for guidance in determining whether the activity results in a betterment, Reg. section 1.263(a)-3(k) for guidance in determining whether there has been a restoration, and Reg. section 1.263(a)-3(l) for guidance in determining whether there has been an adaptation to a new or different use).

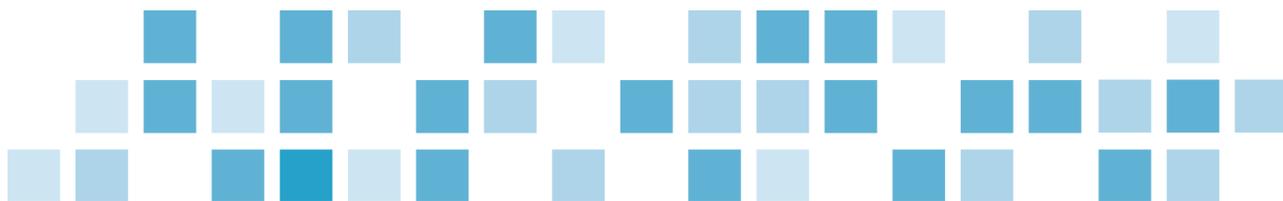
Alternatively, see Reg. section 1.263(a)-3(h) for the small taxpayer safe harbor election. If this applies and the election is made, no costs incurred with respect to repairing or improving the building should be capitalized as improvement costs under Reg. section 1.263(a)-3. Similarly, depending on your planned maintenance procedures for the escalator system, the repair costs could potentially be deductible under the routine maintenance safe harbor of Reg. section 1.263(a)-3(i) (see also, Reg. section 1.263(a)-3(i)(6), examples 13 and 14, which specifically address escalator system repairs and improvements).

Question 11: One of our bank branches had water damage and received insurance proceeds. It is difficult to allocate the historical leasehold improvement costs to the damages. Are we required to capitalize the repairs and then estimate the net book value of the damaged improvements to offset the insurance proceeds? Can we simply net the insurance proceeds against the repair costs and record a small gain/loss?

Answer 11: When an asset is partially disposed of as the result of a casualty event, a taxpayer must recognize the disposition in the amount of the adjusted depreciable basis (assuming no general asset account election has been made for the asset). In determining the adjusted depreciable basis, the taxpayer must determine the unadjusted depreciable basis as defined Reg. section 1.168(b)-1(a)(3) and reduce this amount by the adjustments described in section 1016(a)(2) and (3). A taxpayer may use any reasonable method for purposes of determining the unadjusted depreciable basis of the partially disposed asset (see Reg. section 1.168(i)-8(f)(3) for examples of reasonable methods).

Because there was a casualty event, you would need to reduce the adjusted basis of the asset by the amount of the insurance proceeds. Any costs incurred in repairing the damage would be capitalized (as a restoration) up to the amount of the reduction in the adjusted basis. Any excess would then be subject to the general improvement standards (i.e., betterment, restoration or adaptation) to determine whether the costs are capitalizable improvement costs or deductible repair costs (see Reg. section 1.263(a)-3(k)(4) for a discussion of the limitation on amounts that must be capitalized as restorations of damage from a casualty).

For instance, in your example, if the net book value of the leasehold improvement is reasonably determined to be its adjusted basis and is \$50,000 and you receive \$50,000 in insurance proceeds, you would reduce the basis of the leasehold improvement by \$50,000 to \$0. Assuming \$60,000 was incurred in repairing the damage, \$50,000 of this would be capitalized as a restoration and the remaining \$10,000 would be analyzed in light of the general improvement rules to determine whether they are capitalizable improvement costs (see Reg. section 1.263(a)-3(k)(7), examples 3 and 4).



Dispositions/General asset accounts (GAAs)

Question 12: We made a late GAA election through Form 3115 (method change #180) to take advantage of the flexibility given to assets under GAA in the temporary regulations, as we wanted to continue depreciating building systems assets that had been replaced over time rather than recognizing losses on their prior dispositions. Now that the proposed regulations extend that flexibility to all MACRS assets, can we revoke that late GAA election and the GAA election we made on the 2012 Form 4562?

Answer 12: At this time, the answer is not clear. This will depend on the transition guidance that will be issued to provide rules on adopting or changing methods of accounting to apply the final regulations. At this point, we expect such guidance to be issued sometime in late November or early December. We also expect the transition guidance to address the ability to revoke GAA elections made under the temporary regulations.

Question 13: Is a late GAA election still a good idea for multi-asset accounts (e.g., 25 computers capitalized for \$25,000)?

Answer 13: The answer depends on your goals for tracking, depreciating and disposing of depreciable assets. The purpose of a GAA is to reduce the administrative burden of tracking depreciable assets. If you do not want to track or recognize the disposition of depreciable assets from a multi-asset account, then a GAA election would be desirable.

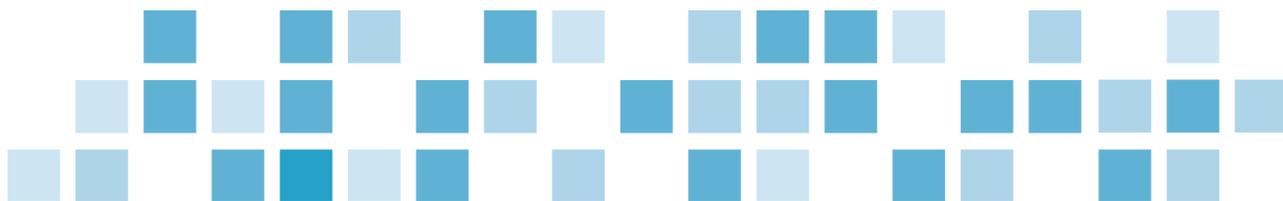
Question 14: Does a GAA election apply to all assets in the account or just the assets placed in service for that year?

Answer 14: Prop. Reg. section 1.168(i)-1 provides rules with respect to electing GAA treatment for tangible property that is depreciable under section 168. There are many rules regarding what can be included in one or more GAAs, but the answer to your question is that a GAA election will apply only to the eligible assets grouped into a single account that are placed in service for the year of the election (see, for example, Prop. Reg. section 1.168(i)-1(c)(3), example 5).

Method change rules

Question 15: Now that the final regulations are here, what should a taxpayer do if they have early adopted a new repair method prior to the 2011 temporary regulations specific to improvements that were previously capitalized?

Answer 15: The final regulations are effective for tax years beginning on or after Jan. 1, 2014, but may be applied to tax years beginning on or after Jan. 1, 2012. A change to apply the improvement standards in the final regulations to determine whether costs should be capitalized as improvements is a change in method of accounting that will likely require the filing of a Form 3115 (i.e., if the present method of determining repair versus improvement costs is not in accordance with the final regulations, a method change will need to be made). The government will be issuing transition guidance that will address how taxpayers should file Forms 3115 to change their methods of accounting to comply with the final regulations. It is currently expected that such guidance will be released in late November or early December.



Question 16: Under the temporary regulations, I heard that most, if not all, businesses would be expected to have to file multiple Forms 3115. That no longer seems true, correct?

Answer 16: The answer depends on the transition guidance that will be issued by the government. It is still true that virtually all taxpayers will be affected by the final and proposed regulations, as they govern the acquisition and maintenance/improvement of all tangible property. However, the final (and proposed regulations) contain many annual elections that are not considered methods of accounting (and therefore cannot be adopted or changed through Forms 3115). Thus, it is possible that fewer Forms 3115 will need to be filed than what was anticipated under the temporary regulations. Ultimately, however, the guidance on this will come from the transition guidance that is expected to be issued in late November or early December.

Question 17: Are there any section 481(a) adjustments (accounting method changes) still available? Or, is everything now by annual elections?

Answer 17: See response to Question 16, above. Although there are many elections in the final and proposed regulations, there are still items that are considered methods of accounting (e.g., a change to use the routine maintenance safe harbor is a change in method of accounting). To the extent a change to adopt a provision of the final regulations will be considered an accounting method change (rather than an annual election), a section 481(a) adjustment will generally be required. However, the transition guidance will address the mechanics of the calculations. The guidance has not yet been issued but is anticipated to be released in late November or early December.

Question 18: Will all companies be required to file Forms 3115 to comply with these new rules? Will Forms 3115 still be required after the rules go into effect in 2014?

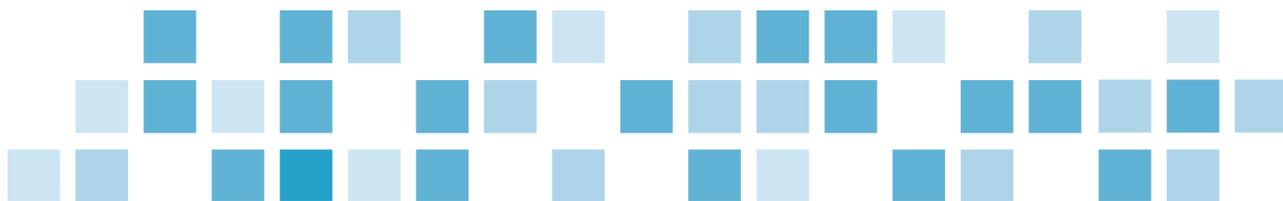
Answer 18: See responses to Questions 16 and 17, above. To the extent that complying with the regulations results in a change in method of accounting, Forms 3115 will likely be required to be filed.

General

Question 19: Have the capitalization rules for GAAP purposes changed also? I see this as having potentially a permanent difference between book and tax because the asset could have a different basis for each.

Answer 19: The treatment of costs for GAAP purposes is not addressed here—the tangible asset and repair regulations only govern the federal income tax treatment of costs to acquire, maintain or improve tangible property.

Question 20: We have a June 30 year end. We do not plan to adopt the final regulations early (i.e., we will adopt effective July 1, 2014). What type of disclosure is required, if any, for our 10-Q for our quarter ending Sept. 30, 2013?

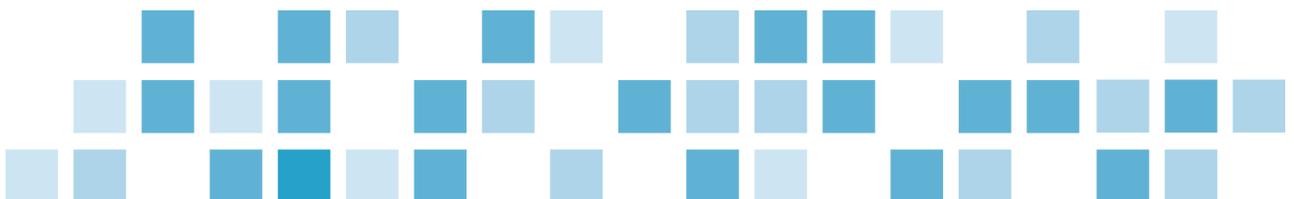


Answer 20: The final regulations should be treated in the same manner as any other change in tax law or rates. Pursuant to ASC 740-10-25-47, the tax effect of a change in tax laws or rates shall be recognized at the date of enactment. For this purpose, the date of enactment is the date that the regulations were issued in final form (i.e., Sept. 19, 2013).

Question 21: Is there a good list of what we really have to worry about in non-technical terms?

Answer 21: There's no list that addresses all areas of concern as this is a taxpayer-specific issue. Generally, though, taxpayers should evaluate how they account for materials and supplies (in light of the expanded and modified definition provided in Reg. section 1.162-3); whether and how they use a de minimis policy for book and/or tax purposes; how they treat costs incurred when acquiring real or personal property; and how they determine when capitalizable repair costs versus deductible repair costs have been incurred (including how they define units of property).

For another resource, see the preambles to the [final](#) and [proposed](#) regulations. These provide a comprehensive explanation of the provisions (including changes from the temporary regulations) in non-technical terms.



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