



Washington National Tax webcast

Capitol Hill update and the final tangible asset regulations

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Agenda

Topic	Time
Capitol Hill update	10 min
Final (and proposed) tangible asset and repair regulations	
Background/overview	5 min
Materials and supplies/de minimis safe harbors/acquisition costs	10 min
Improvements	20 min
Dispositions	10 min

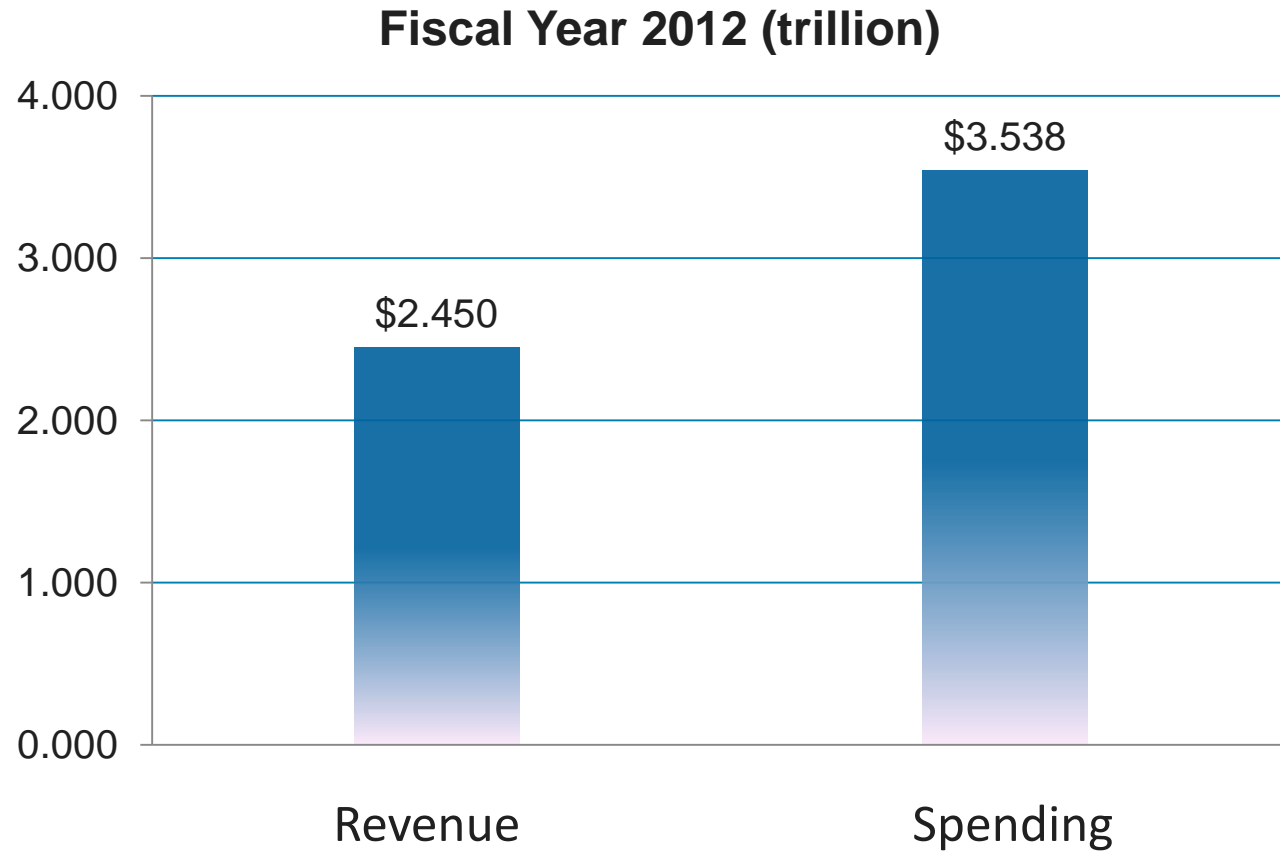
Capitol Hill update

Where are we going?

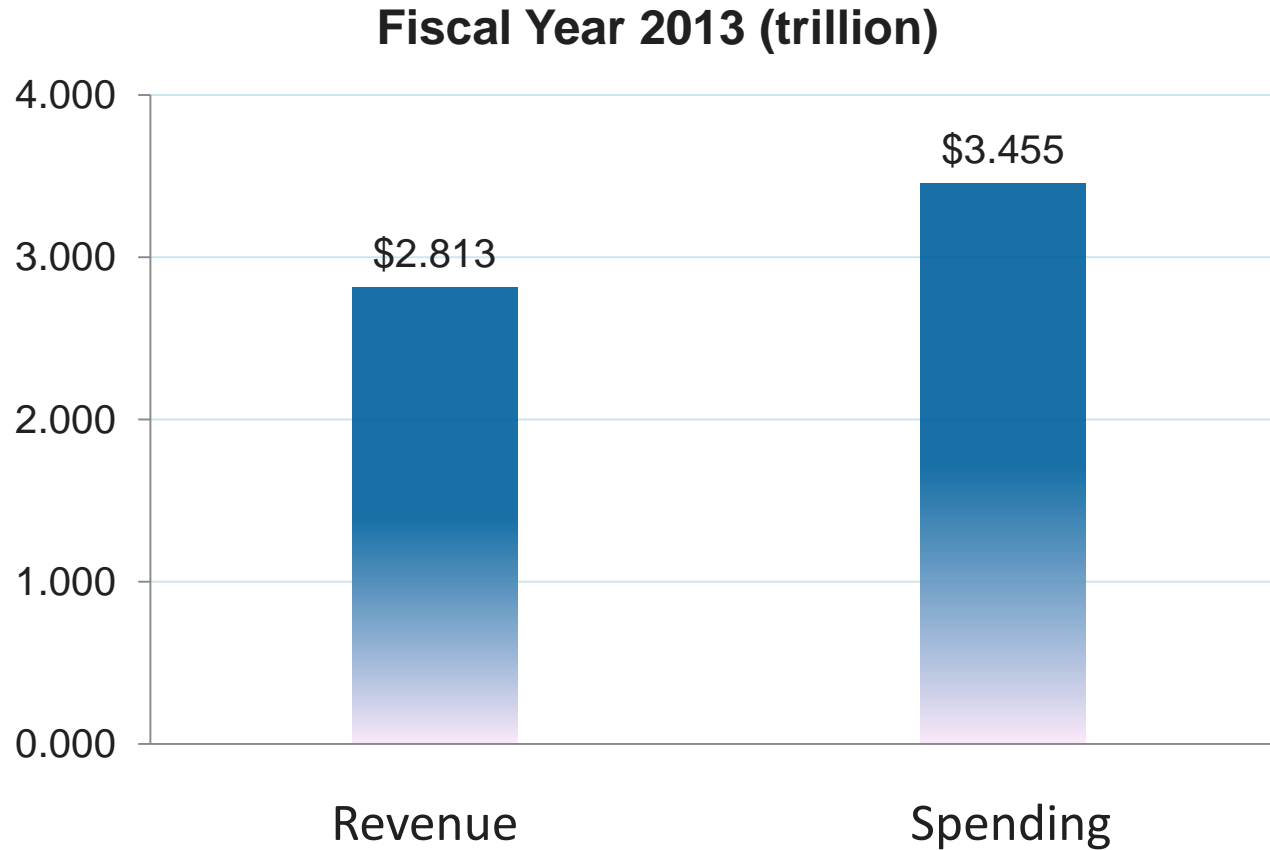
The next 30 days

- Syria
- Continuing resolution
- The debt ceiling

Federal revenue vs. spending for 2012 (actual)



Federal revenue vs. spending for 2013 (estimate)



Closing the deficit

- Economic growth?
- Less spending?
- More revenue?
- Guilty conscience?

Final (and proposed) tangible asset and repair regulations

Timeline

- December 2011
 - Temporary and proposed regulations released
- March 2012
 - Transition/method change rules issued
 - LB&I directive issued
- November 2012
 - Notice 2012-73 issued
- December 2012
 - Technical amendments issued
- March 2013
 - LB&I Directive updated
- Sept. 13, 2013
 - Final and proposed regulations issued
 - Published in Federal Register on Sept. 19, 2013
- October 2013
 - Expected release of new transition/method change rules

Why is this important to you?

- All businesses likely will be affected by the final regulations
- Taxpayers will need to review current capitalization policies/methods
- Many taxpayers will need to file method changes for 2014
- Many taxpayers may want to amend return(s) to make certain elections for 2012 and/or 2013
- Changes might have financial statement implications
- Potential changes to fixed asset accounting systems

Effective dates

Temporary regulations

- Optional for tax years (or amounts paid or incurred in tax years) beginning on or after Jan. 1, 2012 and before Jan. 1, 2014
- Rev. Procs. 2012-19 and 2012-20 provide automatic method change consent procedures

Final regulations

- Optional for tax years beginning on or after Jan. 1, 2012, and before Jan. 1, 2014
- Transition rules provided for making certain elections on amended returns for tax years beginning on or after Jan. 1, 2012, and ending on or before Sept. 19, 2013
- Required for tax years (or amounts paid or incurred in tax years) beginning on or after Jan. 1, 2014
- Automatic method change consent procedures expected in October 2013 and to supersede Rev. Procs. 2012-19 and 2012-20

General framework

Temporary regulations

- Materials and supplies
- Capital expenditures in general
- Costs to acquire or produce tangible property
 - De minimis rule
- Costs to improve tangible property
- Dispositions or general asset accounts (GAAs)

Final regulations

- Materials and supplies
- Capital expenditures in general
 - De minimis safe harbors
- Costs to acquire or produce tangible property
- Costs to improve tangible property
 - Small business safe harbor
- Dispositions or GAAs (proposed)

Materials and supplies—definitions

Temporary regulations

- Component acquired to maintain, repair, or improve UOP, including rotatable or temporary spare parts (rotatables)
- Fuel, lubricants, water, etc. reasonably expected to be consumed in ≤ 12 months, beginning when first used
- UOP with economic useful life of ≤ 12 months, beginning when first used or consumed
- UOP with acquisition or production cost of $\leq \$100$
- Identified in published guidance as materials and supplies

Final regulations

- Same with
 - Addition of standby emergency spare parts, and
 - Acquisition / production cost definition increased to $\leq \$200$

Materials and supplies—methods

Temporary regulations

- Incidental—deduct when purchased; non-incidental—deduct when used or consumed
- Election to capitalize and depreciate any material and supply
- Election to apply de minimis rule to any material and supply
- Rotables—deduct upon disposal, or use optional method for all rotables

Final regulations

- Incidental/non-incidental—same
- Election to capitalize and depreciate only for rotables or standby emergency spare parts (not eligible for de minimis)
- If de minimis safe harbor elected, applies to all eligible materials and supplies except as otherwise provided
- Rotables—same except optional method only for pools of rotables used in same business if also book method
 - If not book method, must use for all pools of rotables in business for tax purposes
 - Not eligible for de minimis

De minimis safe harbor

Temporary regulations

- Taxpayers with Applicable Financial Statement (AFS)
 - Follow book capitalization policy up to ceiling if policy in effect and followed in AFS since beginning of tax year
 - Aggregate de minimis deduction limited to greater of:
 - 0.1 percent of tax gross receipts, or
 - 2.0 percent of total AFS depreciation and amortization
- Taxpayers without AFS
 - Not eligible

Final regulations

- Taxpayers with AFS
 - Same, but no ceiling and only up to \$5,000 per item or invoice, as applicable
- Taxpayers without AFS
 - Follow book capitalization policy up to \$500 per item or invoice, as applicable, if policy in effect and followed in books and records since beginning of tax year

De minimis safe harbor (cont.)

Temporary regulations

- Does not apply to:
 - Inventory property (or items to be included in inventory property)
 - Land
- Method of accounting

Final regulations

- Ineligible amounts expanded to exclude:
 - Rotables or standby emergency spare parts capitalized and depreciated
 - Rotables accounted for under optional method
- Annual election
 - If elected, applies to all eligible property, including eligible materials and supplies
 - Statement with timely-filed original return
- Anti-abuse rule

Costs to acquire or produce UOP

Temporary regulations

- Capitalize amounts paid to:
 - Acquire or produce UOP
 - Defend or perfect title to UOP
 - Facilitate acquisition of UOP
 - Special rules for real property investigatory costs
 - Simplifying convention for employee costs and overhead
 - Exceptions
 - De minimis rule
 - Materials and supplies not capitalized and depreciated

Final regulations

- Same general capitalization rules
 - Clarify definition/treatment of contingency fees
 - Amounts paid contingent on successful closing of acquisition
 - Included in basis of property acquired
 - No allocation to property not acquired
 - Facilitative acquisition costs of property included in de minimis safe harbor election are not capitalizable acquisition costs

Improvements

Determining the UOP

- Rules generally identical from temporary to final regulations
 - General rule—functional interdependence standard
 - Special rules
 - Buildings
 - Leased property
 - Plant property (industrial processes)
 - Network assets
- Final regulations modify rule for determining UOP of certain leasehold improvements
 - Leasehold improvements made by lessee are not treated as UOP separate from the leased property

Removal costs

- Final regulations clarify treatment of removal costs
 - Not required to be capitalized if taxpayer disposes (or partially disposes) of removed asset or component and takes adjusted basis of removed asset or component into account in realizing gain (loss)
 - Cost of replacement asset or component must be capitalized as a restoration
 - If no disposition occurs, removal costs must be analyzed under improvement rules
 - Capitalizable as an improvement if directly benefit or incurred by reason of an improvement to the UOP

Small taxpayer safe harbor

- Final regulations provide safe harbor election for improvements made:
 - To “eligible building property”
 - Eligible building property—a building UOP with an unadjusted basis of \$1,000,000 or less
 - Lessee’s unadjusted basis=total amount of rent paid or expected to be paid under lease
 - By “qualifying taxpayers”
 - Average annual gross receipts for three prior taxable years ≤ \$10,000,000

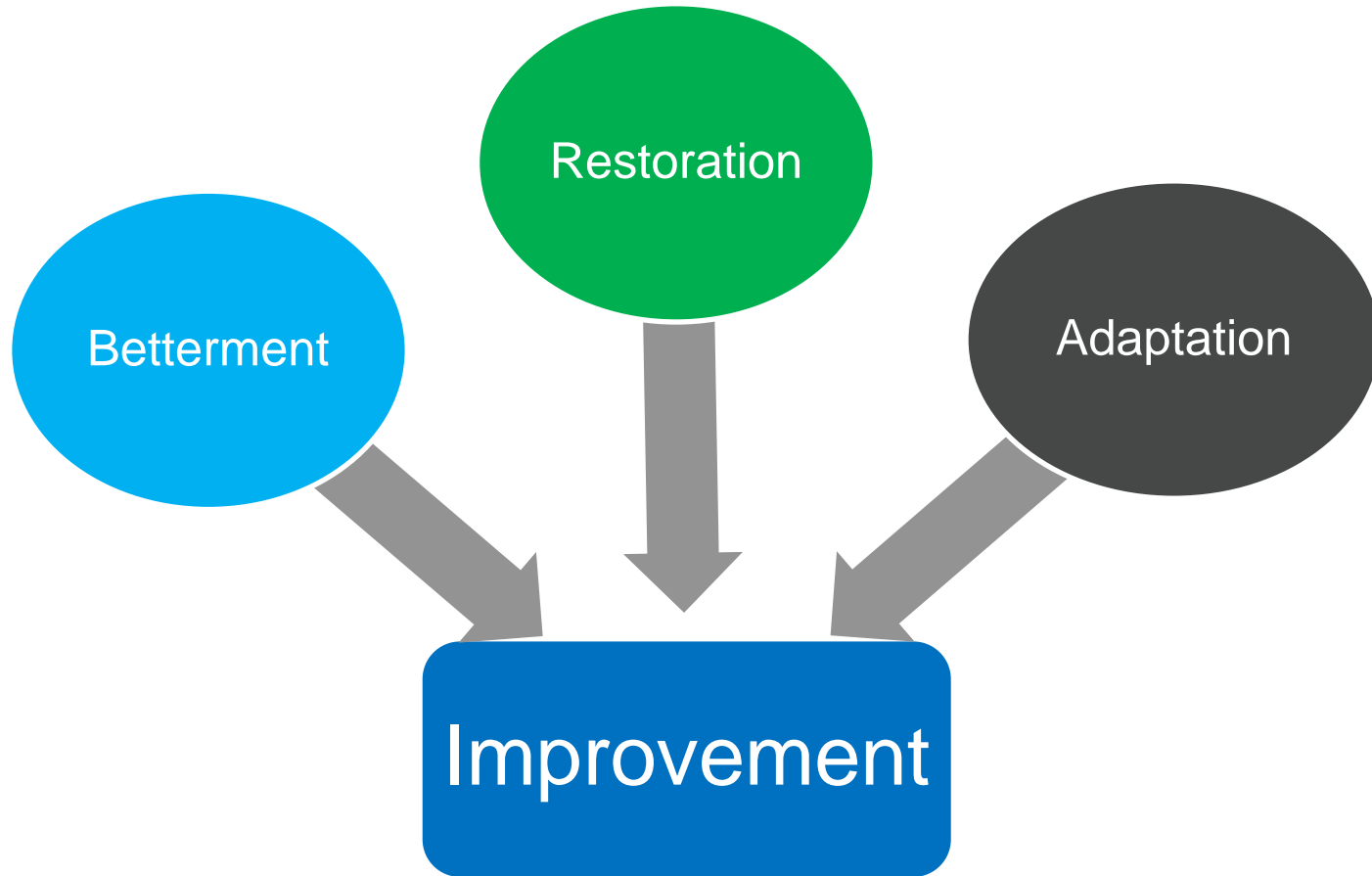
Small taxpayer safe harbor (cont.)

- Not required to apply improvement rules to eligible building if:
 - Total amount paid or incurred during tax year for “repairs, maintenance, improvements, and similar activities” (repairs and maintenance) performed on the building does not exceed lesser of:
 - 2 percent of unadjusted basis of the building, or
 - \$10,000
 - Amounts paid for repairs and maintenance include amounts:
 - Included in de minimis safe harbor (if elected)
 - Deemed not to improve building under routine maintenance safe harbor
 - If limit exceeded, not eligible for small taxpayer safe harbor

Small taxpayer safe harbor (cont.)

- Annual election made:
 - On eligible building-by-building basis
 - By attaching a statement to the timely filed original return (including extensions) for tax year in which amounts for the repair and maintenance are paid or incurred
- Amounts subject to election deductible in year paid or incurred if otherwise deductible under section 162 or 212

Framework unchanged from temporary regulations



Betterments

- Final regulations generally comply with temporary regulations, with certain modifications
 - Addition of major component to UOP
 - Amount paid or incurred is “reasonably expected to” materially increase the productivity, efficiency, strength, quality, or output of the UOP
 - Rather than “result in” language of temporary regulations
 - Application of each quantitative and qualitative factor dependent on nature of UOP
 - Removal of AFS treatment as factor to consider
 - Appropriate comparison rule focuses on events affecting condition of property (not business decisions made)
- No bright-line tests
 - Additional detail in examples to clarify application of rules

Restorations

- Final regulations generally same as temporary regulations but revise major component and casualty loss rules and add salvage value exception
- Replacement of major component or substantial structural part
 - Definitions of “major component” (function) and “substantial structural part” (size) clarified
 - Minor/incidental components generally not major components even if perform discrete/critical function (e.g., switch)
 - New definition for buildings
 - Replacement of major component or “significant portion of a major component” of building structure/system
 - Large portion of building structure/system
 - Examples added and modified to clarify application of rules

Restorations (cont.)

- Casualty loss rule
 - If required to take basis adjustment related to casualty loss:
 - Amount capitalized as restoration limited to excess of:
 - Adjusted basis for determining allowable casualty loss, over
 - Amount paid for restoration that also constitutes an improvement under any other restoration provision
 - Amounts in excess of limitation subject to general improvement analysis
- Salvage value exception
 - Replacement of component deducted as loss or where basis is adjusted for sale or exchange
 - Not required to capitalize as restoration where loss on UOP attributable only to remaining salvage value

Adaptations

- Rules retained, but three new illustrative examples added
 - Retail drugstore adds walk-in medical clinic = adaptation
 - Grocery store adds sushi bar ≠ adaptation
 - Hospital modifies emergency room to provide both emergency care and outpatient surgery ≠ adaptation

Routine maintenance safe harbor

- Final regulations expand safe harbor to building property and provide additional exclusions
- Application to building property (including building systems)
 - Taxpayer reasonably expects to perform activity more than once within 10 years of the placed-in-service date of the building or building system
- Application to non-building property
 - Taxpayer reasonably expects to perform activity more than once during UOP's Alternative Depreciation System class life

Routine maintenance safe harbor (cont.)

- Final regulations add ineligible items:
 - Betterments
 - Adaptations
 - Amounts paid for repair, maintenance or improvements of network assets
- Determining reasonableness of expectation
 - Expectation not deemed unreasonable just because expected maintenance not performed more than once during relevant period
 - However, taxpayer's experience is a factor in determining reasonableness of expectation for subsequent similar UOP

Election to capitalize repair and maintenance costs

- Final regulations provide annual election to capitalize repair and maintenance costs IF:
 - Incurred in carrying on a trade or business
 - Treated as capital expenditures in books and records
- Election applies to all repair and maintenance amounts capitalized for book purposes
 - Costs treated as improvements to tangible property
 - Depreciation begins when improvements placed in service
 - Election made by attaching statement to timely filed tax return (including extensions) for year in which amounts are paid or incurred
 - Does not apply to repairs of rotables accounted for under optional method

Dispositions

Proposed regulations

- Proposed regulations
 - GAAs
 - Dispositions of MACRS property
- May be applied to taxable years beginning on or after Jan. 1, 2012, and before applicability date of final regulations
 - Transition rules for certain elections for years in which the timely filed tax return has already been filed
- Taxpayers may apply temporary regulations to taxable years beginning on or after Jan. 1, 2012, and ending on or before Sept. 19, 2013

General asset accounts (GAAs)

- Taxpayer may elect to recognize qualifying disposition of an asset or portion of an asset
 - Proposed regulations narrow definition of qualifying disposition
 - Now in accordance with final regulations in effect prior to temporary regulations
- Determining unadjusted depreciable basis of disposed asset
 - Examples of reasonable methods where determination is impracticable from taxpayer's records
 - Non-exclusive list

Proposed regulations

Temporary regulations

- Separate asset for disposition purposes:
 - Each building (excluding structural components)
 - Each structural component of a building
- Requires recognition of gain (loss) upon disposition of structural component unless component in GAA
- Annual GAA election
 - Annual qualifying disposition election

Proposed regulations

- Building (including structural components) is the asset
 - Not separate assets for disposition purposes unless make partial disposition election
 - No GAA election necessary to forego disposition loss
- Dispositions only include structural components if taxpayer makes partial disposition election
 - Annual election for any MACRS property
 - Statement with timely-filed return for year of disposition
 - Required for specified transactions (sale or sections 165, 168(i)(7), 1031 and 1033)
- Special rule for IRS adjustments to repairs

Summary of annual elections under final regulations

- Annual elections
 - Capitalize and depreciate rotables or standby emergency spare parts
 - De minimis safe harbor
 - Capitalize employee compensation and/or overhead
 - Small taxpayer safe harbor
 - Capitalize repair and maintenance costs
 - Recognize partial dispositions
- Transition rule for annual elections
 - For tax years beginning on or after Jan. 1, 2012, and ending on or before Sept. 19, 2013
 - If tax return was timely filed, have 180 days from extended due date (even if did not extend) to amend and make election

Questions?

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