State tax implications of federal tangible property repair regulations

October 22, 2013

In brief

The recently released federal tangible personal property repair regulations should affect the federal taxable income calculation of every taxpayer that acquires, produces, improves, or disposes of tangible personal property. Taxpayers should review federal conformity provisions in states where they file corporate income tax returns to determine whether the federal repair regulations will be adopted for state tax purposes. When analyzing these regulations for state corporate income tax purposes, there are several opportunities and risks that a taxpayer should consider.

In detail

Tangible personal property repair regulation background

On September 13, 2013, the Internal Revenue Service released its final tangible property 'repair' regulations (final regulations) regarding the deduction and capitalization of expenditures related to tangible property under Internal Revenue Code (IRC) sections 162(a) and 263(a). The final regulations replace temporary regulations that were issued in December 2011. These regulations will affect every taxpayer that acquires, produces, improves, or disposes of tangible property, especially those that previously filed a related accounting method change. In general, these final regulations apply to taxable years beginning on or after January 1, 2014. Taxpayers may choose to apply the final regulations to any tax year beginning on or after January 1, 2012.

Generally, any change to comply with the final regulations is a change in the method of accounting to which the provisions of IRC sec. 446(e) and associated regulations apply. The final regulations generally require a full IRC sec. 481(a) adjustment, which means taxpayers should evaluate their current methods of accounting for any methods governed by the final regulations to determine what changes, if any, are required to conform to these new rules. If a federal accounting method change is filed, then taxpayers should consider what should be included for state tax purposes to provide appropriate notice.

Further, in separate company filing states, consideration should be given to the entity in the consolidated group that the federal change specifically affects.

State tax considerations – Conformity to federal regulations

Because state taxable income is generally tied to federal taxable income, a state's conformity to the IRC and related regulations determines whether a new federal law or regulation is adopted by the state. Federal conformity is generally addressed in one of three ways:

- **Rolling conformity** – A state should conform to all new federal provisions as they become effective. For example, New York provides that a taxpayer's net income base starts with federal taxable income before NOLs and special deductions "as required to be reported to the US Treasury Department." Also, Illinois provides that the IRC "in effect for the taxable year" is incorporated by reference. However, even a rolling conformity state may choose to decouple from a federal income tax provision (e.g., bonus depreciation).

Even with rolling conformity states, consideration should be given to whether the states' rolling conformity provisions should broadly include the adoption of the federal regulations and specifically these repair regulations.

- **Fixed-date conformity** – A state conforms to the IRC only as of a specific date, resulting in an effective 'decoupling' from federal changes occurring after that date. For example, Oregon conforms to the IRC "as amended and in effect on January 3, 2013."
- **Selected provisions adopted or decoupled from**. As a matter of policy, some states may choose which federal provisions to follow and which ones to exclude. For example, California generally provides its own treatment of federal provisions. The Franchise Tax Board publishes an annual summary of the state's conformity to federal tax changes.

Taxpayers will have to answer several questions regarding when (or if) the final regulations will impact their state tax reporting. What is the federal conformity rule in each state? If it's rolling conformity, then does the state intend to decouple from the final regulations? If it's fixed-date conformity, then does the state intend to adopt the final regulations? Does the state's conformity rule apply to final regulations? Are separate state elections required?

State implications

To the extent the final regulations are not adopted (or partially adopted) by a particular state, a taxpayer will have to address several issues, including:

- **Basis discrepancies.** Failing to adopt, fully or partially, the final regulations could result in a property possessing a different state basis than its federal basis.
- **Property tax impact.** The value of a company's tangible personal property may change as a result of the final regulations. A company should revisit its valuation of tangible personal property for state property tax purposes.
- **Financial statement implications.** A state's conformity to a new federal regulation raises the potential for book-to-tax differences. Affected taxpayers should evaluate the impact of the final regulations on their financial statements.

Additional reading

For more detail regarding the federal repair regulations, please read the following PwC Insights:

- Final tangible property repair regulations and proposed regulations: Dispositions, general asset accounts, recovery of certain capital improvements, and removal costs (October 7, 2013)
- Final tangible property repair regulations: Unit of property and acquisition or improvement of property (September 26, 2013)
- Final tangible property repair regulations: Effective dates, materials and supplies, de minimis rule, and rotable spare parts (September 18, 2013)
- IRS releases long-awaited final tangible property 'repair' regulations (September 13, 2013)

The takeaway

Taxpayers should conduct a state-by-state analysis regarding the impact of the final regulations. There are many nuances within the final regulations and it will likely take the states some time to provide guidance on their interpretations of these rules. Additionally, certain industries have very specific rules resulting from these changes that will need to be analyzed from a state tax perspective. Therefore, companies should consider a statewide review of how the final regulations may affect their state tax liabilities.

Let's talk

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