

# PCS Tax Insight

Private Company Services Publication

August 6, 2012

*Private companies should analyze the impact of the new tangible property regulations*

*New temporary regulations likely will require many private companies to change their tax accounting methods for tax years beginning on or after January 1, 2012.*

## Background

On December 23, 2011, the IRS published proposed and temporary regulations under section 263(a) on the deduction and capitalization of expenditures related to tangible property.

Although they are commonly referred to as the "repair" regulations, the temporary regulations are broadly applicable to all taxpayers that acquire, produce, or improve tangible property, and provide guidance regarding areas beyond the tax treatment of costs incurred for repair and maintenance expenditures. The temporary regulations also provide guidance with respect to general asset accounts (GAAs) and dispositions of depreciable property.

The temporary regulations are generally effective for tax years beginning on or after January 1, 2012. However, certain provisions are effective for amounts paid or incurred in tax years beginning on or after January 1, 2012.

For an in-depth technical analysis of the repair regulations, see the following WNTS Insights:

- ["Effective dates, units of property, and dispositions,"](#) January 4, 2012;
- ["Acquisition or improvement of property,"](#) January 5, 2012; and
- ["Plan of rehabilitation, environmental remediation, rotatable spare parts, general asset accounts, removal costs, and recovery of certain capital improvements,"](#) January 6, 2012.



---

## *What is new with the temporary regulations?*

### **Unit of property (UOP)**

The temporary regulations significantly modify the UOP rules with respect to a building and its structural components. In particular, the temporary regulations provide that taxpayers must apply the capitalization standards under section 263(a) separately to the building structure and to each specifically defined building system. Building systems are defined only to include the HVAC system, plumbing system, electrical system, all escalators, all elevators, fire protection and alarm systems, security system, gas distribution systems, and any other systems defined in published guidance.

For property other than buildings, the temporary regulations provide that the UOP for plant property is based on a major and discrete function analysis, and for machinery and equipment the UOP generally is based on a functional interdependence test.

### **Dispositions**

The temporary regulations allow a taxpayer to claim a retirement loss for a structural component of a building or major building system, and thus permit a taxpayer to claim a retirement loss when such structure or system is replaced with a capital improvement. Under prior law, a taxpayer could claim a retirement loss for worn or damaged components that are discarded from the taxpayer's operations when such a loss was not previously allowed. This rule was promulgated to provide an equitable result that does not require a taxpayer to, for example, depreciate an electrical system that has been removed and replaced with an updated system.

### **General asset accounts**

The prior-law rules for general asset accounts allow a taxpayer to elect to terminate GAA treatment for an asset in a GAA when the taxpayer disposed of the asset in a "qualifying disposition." The temporary regulations expand the definition of a qualifying disposition to include most dispositions that are realization events. Taxpayers generally are precluded from realizing a loss on the disposition of individual assets from a GAA (absent a second election to recognize gain or loss on a qualifying disposition). Instead, a taxpayer following the GAA rules generally is required to account for the disposition of assets according to the specific disposition rules.

The changes to the GAA rules are significant in that a taxpayer that affirmatively makes such an election will have benefits that previously were not available. For example, a taxpayer that affirmatively elects to include property in a GAA effectively has the choice of whether to recover the basis of property disposed of in a qualifying disposition; a taxpayer that is not using a GAA does not have this choice.

### **De minimis rule**

Under the de minimis rule, amounts paid to acquire or produce tangible property (including facilitative costs) and, at the election of the taxpayer, to acquire or produce any material or supply, are not required to be capitalized (i.e., these costs are currently deductible to the extent the aggregate amount does not exceed a certain dollar threshold).

---

The temporary regulations provide a revised "ceiling" that the aggregate of such amounts paid cannot exceed. In general, the ceiling caps the aggregate amount deductible for a tax year to an amount that is less than or equal to the greater of the following:

- (i) 0.1 percent of the taxpayer's gross receipts for the tax year as determined for Federal income tax purposes, or
- (ii) 2 percent of the taxpayer's total depreciation and amortization expense for such tax year as determined in its applicable financial statement (AFS).

**Observation:** The IRS has commented publicly that the ceiling is not meant to be an all-or-nothing rule. That is, the IRS intended that a taxpayer is required to capitalize only amounts in excess of the ceiling, and may currently deduct the amount below the ceiling. The IRS noted that the final regulations will be revised to reflect this intent.

The temporary regulations define an AFS as a certified audited financial statement that is accompanied by the report of an independent certified public accountant that is used for credit purposes or any other substantial non-tax purpose. *Note:* The de minimis rule is available *only* to taxpayers with an AFS. *Observation:* Taxpayers without an AFS may look to analyze case law to support the use of a capitalization threshold.

A taxpayer also is required to have, at the beginning of its tax year, written accounting procedures treating as an expense for non-tax purposes the amounts paid for property costing less than a certain dollar amount, and providing that such amounts are actually expensed for AFS purposes in accordance with such written policy.

Private companies that currently follow the capitalization policy used for financial accounting purposes may find that they are required to capitalize costs in excess of the amount capitalized for book purposes, unless the threshold calculated under the de minimis rule is less than or equal to the amount capitalized for book purposes. The lack of outright book/tax conformity in favor of a mathematical ceiling likely will cause some administrative burdens for taxpayers.

**Observation:** Many taxpayers had hoped that the IRS would allow the use of the book standard for Federal income tax purposes, without a ceiling. Because the IRS did not do so, this creates a significant question of whether the IRS's creation of the safe harbor, presumably designed to help taxpayers achieve certainty, will have any impact on the thousands of US businesses that use their book capitalization threshold for Federal income tax purposes.

The preamble to the temporary regulations addresses this issue by providing that taxpayers' prior practices are acceptable as long as taxpayers that use a capitalization threshold that exceeds the safe harbor amount demonstrate that doing so clearly reflects income. Because taxpayers always have the burden of demonstrating that their treatment of timing items clearly reflects income, this statement would appear to signal that the IRS prior practice for those taxpayers with capitalization thresholds in excess of the safe harbor.

---

## Accounting method changes

The temporary regulations make significant changes to prior law. It is likely that many private-company taxpayers will need to change their methods of accounting to comply with the new rules. Taxpayers seeking to change their methods of accounting to comply with the temporary regulations for tax years beginning on or after January 1, 2012, must file Form(s) 3115, *Application for Change in Accounting Method*, with the IRS.

### New automatic accounting method changes

On March 7, 2012, the IRS released Revenue Procedures 2012-19 and 2012-20 providing automatic accounting procedures and transition rules relating to the temporary regulations.<sup>1</sup> These revenue procedures add new automatic accounting method changes for taxpayers seeking to change their methods of accounting in connection with the deduction and capitalization of expenditures related to tangible property, and with the new depreciation and dispositions rules under the temporary regulations.

### Audit protection

The temporary regulations do not modify the general rule affording audit protection or "amnesty" for a taxpayer that voluntarily changes from the taxpayer's previous method of accounting to a method permitted by the temporary regulations. Specifically, under this amnesty approach, a taxpayer that voluntarily changes to a method of accounting in accordance with the regulations receives a commitment from the IRS that it will not make an examination adjustment relating to the taxpayer's use of the previous method for any prior tax year.

### LB&I directive

Following the release of the revenue procedures, the IRS Large Business and International Division (LB&I) issued a directive providing guidance to IRS examiners regarding taxpayers that adopted a method of accounting relating to the conversion of capitalized assets to repair expense under section 263(a).

The directive applies to exam activity relating to positions taken on original returns regarding:

- (i) whether costs incurred to maintain, replace, or improve tangible property must be capitalized under section 263(a), and
- (ii) any correlative issues involving the disposition of structural components of a building or dispositions of tangible depreciable assets (other than a building or its structural components).

---

<sup>1</sup>For an in-depth technical analysis of the revenue procedures, see the following WNTS Insights:

- "[Accounting method changes under the tangible property regulations: deduction and capitalization of expenditures](#)," March 13, 2012; and
- "[Accounting method changes under the tangible property regulations: depreciation and dispositions of property](#)," March 13, 2012

The LB&I directive instructs IRS examiners to discontinue current examinations of tax years beginning before January 1, 2012, and refrain from beginning any new examination issues relating to the items discussed above.

However, for tax years beginning on or after January 1, 2012, but before January 1, 2014, the directive instructs examiners to determine whether the taxpayer has filed a Form 3115 and, if so, to perform a risk assessment regarding the method change. If the taxpayer has not filed a Form 3115, and the taxpayer is still in its first or second tax year beginning after December 21, 2011 (the "waiver period"), the examiner is directed not to examine the issues and allow the taxpayer until the end of the waiver period to file a Form 3115. If the taxpayer has not filed a Form 3115 and the waiver period has expired, then the examiner is instructed to perform a risk assessment regarding the issues.

Examiners are instructed to follow normal exam procedures for examinations of tax years beginning on or after January 1, 2014.

### *What are next steps for private companies?*

For tax years beginning on or after January 1, 2012, private companies should review their current methods of accounting in light of the temporary regulations to determine if a Form 3115 is required. If an accounting method change is required, then they should review the new revenue procedures to assess which method changes should be filed in 2012 and/or 2013 to comply with the temporary regulations. Taxpayers also should consider calculating the amount deductible under the de minimis rule and ensure all requirements are satisfied (e.g., written accounting procedures at the beginning of the tax year) if they believe they will rely on the safe harbor rule. At a minimum, private companies should work to understand how the temporary regulations will affect them and implement policies and procedures to comply with the regulations.

*For more information, please do not hesitate to contact:*

<i>George Manousos</i>	<i>(202) 414-4317</i>	<i>george.manousos@us.pwc.com</i>
<i>Robert Love</i>	<i>(414) 212-1723</i>	<i>robert.love@us.pwc.com</i>
<i>Sara Logan</i>	<i>(202) 414-1417</i>	<i>sara.l.logan@us.pwc.com</i>
<i>Richard Stovsky</i>	<i>(216) 875-3111</i>	<i>richard.p.stovsky@us.pwc.com</i>
<i>Gregg Muresan</i>	<i>(216) 875-3504</i>	<i>gregg.g.muresan@us.pwc.com</i>

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

SOLICITATION

© 2012 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.