Final tangible property repair regulations: Effective dates, materials and supplies, de minimis rule, and rotable spare parts

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In brief

This WNTS Insight is the first in a three-part series that will discuss in depth the recently issued final regulations regarding the deduction and capitalization of expenditures related to tangible property, as well as the re-proposed regulations regarding the disposition of assets. This Insight focuses on rules related to effective dates, materials and supplies, a de minimis safe harbor rule, and rotable spare parts. The second WNTS Insight in this series will discuss rules related to the unit of property and the acquisition or improvement of property. The third WNTS Insight will address additional topics not previously discussed, including the recovery of capital improvements subject to lease, removal costs, and the proposed regulations regarding the disposition of tangible depreciable property.

In detail

Background

The IRS and Treasury Department on September 13, 2013, released final regulations under Sections 162(a) and 263(a) on the deduction and capitalization of expenditures related to tangible property (the final repair regulations). These regulations have been a priority guidance project for approximately nine years, having been announced initially in 2004 in an Advance Notice of Proposed Rule Making, proposed in regulations in August 2006, re-proposed in March 2008, and issued in temporary form in December 2011 (the 2011 temporary regulations).

The final repair regulations retain many of the provisions from the 2011 temporary regulations. However, the final repair regulations refine and simplify some of the rules contained in the 2011 temporary regulations and create a number of new safe harbors. Consistent with the 2011 temporary regulations, the final repair regulations contain provisions that may be beneficial for some taxpayers but unfavorable for others.

Effective dates and changes in methods of accounting

Effective dates of the final repair regulations

The entirety of the final repair regulations apply to tax years beginning on or after January 1, 2014. However, the following rules apply only to amounts paid or incurred in tax years beginning on or after January 1, 2014:

- Materials and supplies (Reg. sec. 1.162-3);
- The de minimis rule or "capitalization threshold" related to the acquisition or

production of property (Reg. sec. 1.263(a)-1(f));

- The special rule for costs related to the acquisition of real property (Reg. sec. 1.263(a)-2(f)(2)(iii));
- Employee compensation and overhead costs related to the acquisition of real or personal property (Reg. sec. 1.263(a)-2(f)(2)(iv));
- The treatment of inherently facilitative amounts related to the acquisition or production of real or personal property (Reg. sec. 1.263(a)-2(f)(3)(ii));
- The safe harbor for small taxpayers for improvements to a unit of property and improvements to leased property (Reg. sec. 1.263(a)-3(h));
- The optional regulatory accounting method for amounts paid to repair, maintain, or improve tangible property (Reg. sec. 1.263(a)-3(m));
- The election to capitalize repair and maintenance costs (Reg. sec. 1.263(a)-3(n));
- Section 263A direct material costs (Reg. sec. 1.263A-1(e)(2)(i)(A)); and
- Section 263A indirect material costs (Reg. sec. 1.263A-1(e)(3)(ii)(E)).

Taxpayers may choose to apply the final repair regulations to any tax year beginning on or after January 1, 2012. For taxpayers choosing to 'early adopt' the final repair regulations, they will apply to tax years beginning on or after January, 1, 2012, or to amounts paid or incurred in tax years beginning on or after January 1, 2012, as applicable.

The final repair regulations provide taxpayers choosing to early adopt the regulations with transition relief to the extent such taxpayers failed to make certain elections on their timely filed original federal tax return for their 2012 or 2013 tax year. In these situations, taxpayers are permitted to make certain elections by filing an amended federal tax return for 2012 or 2013 (as applicable) on or before 180 days from the due date (including extensions) of the taxpayer's federal tax return for such year.

Taxpayers also may choose to apply the 2011 temporary regulations to tax years beginning on or after January 1, 2012, and before January 1, 2014. However, taxpayers cannot apply the 2011 temporary regulations to tax years beginning on or after January 1, 2014.

Observation: Taxpayers now have several options for any tax year beginning on or after January 1, 2012, and on or before January 1, 2014. For any such tax year, a taxpayer may (i) continue with its existing methods of accounting, (ii) early adopt the 2011 temporary regulations, or (iii) early adopt the final repair regulations. However, every taxpayer must conform to the final repair regulations beginning with its first tax year beginning on or after January 1, 2014.

Changes in method of accounting

In general, any change to comply with the final repair regulations is a change in method of accounting to which the provisions of Section 446(e) and the regulations thereunder apply.

The final repair regulations generally require a full Section 481(a) adjustment, which means taxpayers should evaluate their current methods of accounting for any methods governed by the final repair regulations to determine what changes, if any, are required to conform to these new rules. However, the de minimis rule and the several other provisions noted above are implemented on a cut-off basis rather than with a Section 481(a) adjustment, which means those methods of accounting apply to amounts paid or incurred after January 1, 2014.

Observation: The general requirement that the final repair regulations require a Section 481(a) adjustment means that taxpayers that currently use a *more* favorable method of accounting for repairs than permitted under the final repair regulations will have to give back some of the benefit. Likewise, taxpayers that currently use a *less* favorable method will be able to claim missed repair deductions. If a Section 481(a) adjustment is required, the cumulative effect of the change in method of accounting -- including any Section 481(a) adjustments from prior repairs method changes -- must be reflected in the adjustment.

Observations: The IRS noted in the preamble to the final repair regulations that the imposition of a Section 481(a) adjustment provides for a uniform and consistent rule for all taxpayers that will ultimately reduce the administrative burden on taxpayers and the IRS. Further, requiring a Section 481(a) adjustment ensures that all taxpayers are on the same method(s) of accounting for costs incurred both before and after the effective date of the final repair regulations.

Any taxpayer that previously incurred expenses to repair or improve tangible property will be required to conform prior years' expenditures to the rules contained in the final repair regulations. In particular, taxpayers that performed a repairs study in the past likely will have to revisit those studies and analyze their past-year

expenditures in accordance with the final repair regulations.

Pending guidance

The preamble to the final repair regulations confirms that the IRS will issue separate revenue procedures that will provide procedures under which taxpayers may obtain automatic consent to change their methods of accounting to comply with the final repair regulations for tax years beginning on or after January 1, 2012. We expect these revenue procedures to be issued in the coming weeks.

We also expect the revenue procedures to provide audit protection for all tax years prior to the tax year for which a taxpayer changes its methods of accounting to comply with the final repair regulations, and to provide other necessary procedural rules, such as whether any resulting Section 481(a) adjustment is taken into account over the traditional spread period -- in the year of change for a taxpayer-favorable Section 481(a) adjustment (a reduction in taxable income) and ratably over four tax years for a taxpayer-unfavorable Section 481(a) adjustment (an increase in taxable income).

Further, we expect the revenue procedures to reduce the number of changes in methods of accounting that may be necessary to comply with the final repair regulations from the 19 different method changes that were prescribed under the 2011 temporary regulations.

Materials and supplies

The final repair regulations are consistent with the 2011 temporary regulations and provide that non-incidental materials and supplies are deductible as used or consumed, while incidental materials and supplies are deductible when purchased if no consumption records or inventory records are maintained, provided taxable income is clearly reflected.

The final repair regulations retain the election to capitalize certain materials and supplies and treat as an asset subject to the allowance for depreciation. However, unlike the 2011 temporary regulations -- which permitted this election to be made for any materials and supplies -- the final regulations permit the election to be made only for rotable, temporary, or standby emergency spare parts. Taxpayers may elect annually to capitalize and depreciate rotable, temporary, or standby emergency spare parts by making the election on a timely filed federal income tax return, including extensions, for the tax year the asset is placed in service by the taxpayer for purposes of determining depreciation.

An expanded definition of materials and supplies in the 2011 temporary regulations is maintained in the final repair regulations, as are the alternative optional method of accounting for rotable and temporary spare parts (see further discussion under "Rotables and temporary spare parts" below), and the election to treat certain materials and supplies under the de minimis rule (see further discussion under "De minimis rule" below).

The final repair regulations define materials and supplies as tangible property that is used or consumed in the taxpayer's operations, is not inventory, and:

- Is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and is not acquired as part of any single unit of tangible property;
- Consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations;
- Is a unit of property as determined under Reg. sec. 1.263(a)-3(e) that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;
- Is a unit of property as determined under Reg. sec. 1.263(a)-3(e) that has an acquisition cost or production cost of $200 or less (note that this $200 limit has been increased from the $100 limit in the 2011 temporary regulations); or
- Is identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as materials and supplies for which treatment under Reg. sec. 1.162-3 is permitted.

The final regulations clarify that prior published guidance (e.g., Rev. Proc. 2002-12 regarding the treatment of smallwares, and Rev. Proc. 2002-28 regarding the treatment of certain inventoriable items for qualifying small-business taxpayers) is not superseded, obsoleted, or replaced by the final repair regulations to the extent such prior guidance deems certain property to constitute materials and supplies.

De minimis rule

The final repair regulations, like the 2011 temporary regulations, provide a de minimis rule, but incorporate a number of substantive changes, including elimination of the ceiling rule, addition of an invoice- and item-level safe harbor, inclusion of a de minimis rule for taxpayers without an applicable financial statement (AFS), and clarification of when and how an election is made.

Pursuant to the de minimis rule in the final repair regulations, a taxpayer may elect to expense the cost of acquired property that does not exceed a certain dollar amount.

However, the final repair regulations eliminate the "ceiling" established in the 2011 temporary regulations.

In place of the "ceiling" rule, the final repair regulations provide for a new de minimis safe harbor to be applied at the invoice or item level, based on the policies that the taxpayer uses for its financial accounting books and records. The invoice or item dollar limit relies upon whether a taxpayer produces an AFS. Taxpayers with an AFS are allowed a $5,000 per invoice or item limit. For example, if a taxpayer purchases 100 computers at $2,000, that taxpayer would be eligible to elect to use the de minimis rule and expense such computers when purchased (assuming all other requirements of the de minimis rule are satisfied).

Unlike the de minimis safe harbor in the 2011 temporary regulations, the de minimis safe harbor in the final repair regulations has been expanded to allow taxpayers without an AFS to elect application of the de minimis rule. If accounting procedures are in place, taxpayers without an AFS may rely on the de minimis safe harbor only if the amount paid for property does not exceed $500 per invoice or item.

The final repair regulations also permit a taxpayer that does not prepare its own AFS to rely on the de minimis safe harbor if the taxpayer's financial results are reported on the AFS of its parent's group (and all other requirements of the de minimis rule are satisfied). As a result, foreign inbound companies now will be eligible to rely on the de minimis rule safe harbor if their results are reported in their foreign parent's AFS.

The final repair regulations provide that the newly established per-invoice or per-item de minimis rule is a safe harbor that may be elected annually. The final repair regulations further provide that the de minimis safe harbor must be applied to all amounts paid in the tax year for tangible property that meet the requirements of the de minimis safe harbor, including materials and supplies. Taxpayers may not revoke an election to use the de minimis safe harbor. In general, as an election the de minimis safe harbor may not be made through the filing of an application for change in accounting method or via an amended return.

The final repair regulations clarify the interaction between the de minimis safe harbor and Section 263A. When tangible property is acquired with the expectation of being used in the production of other property, and it is likely that production will occur at some future date, Section 263A may require taxpayers to capitalize the cost of the property acquired. If the amounts paid for tangible property comprise direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale, then Section 263A likely will apply.

Alternatively, if property is acquired without an expectation of being used in the production of property and the taxpayer elects and properly applies the de minimis rule to the amounts paid for property in the tax year, then Section 263A will not apply, even if the expectations change in a subsequent tax year, resulting in the use of that property in production.

***Observations*:** Similar to language in the preamble to the 2011 temporary regulations, the preamble to the final repair regulations states that the de minimis rule is not intended to prevent a taxpayer from reaching an agreement with its IRS examining agent that, as an administrative matter, based on IRS examining agents' risk analysis or materiality thresholds, the examining agent will not review certain items.

The preamble also states that if an examining agent and the taxpayer agree that certain amounts in excess of the de minimis rule limitations are immaterial and should not be subject to review, then that agreement should be respected, notwithstanding the requirements of the de minimis rule. However, the preamble states that taxpayers that seek a deduction for amounts in excess of the amount allowed by the de minimis rule will have the burden of showing that such treatment clearly reflects income.

Observation: To be able to avail itself of the de minimis rule safe harbor, a calendar-year-end taxpayer must ensure that, among other things, as of January 1, 2014, it has written accounting procedures in place treating as an expense for non-tax purposes amounts paid for property costing less than a specified dollar amount or amounts paid for property with an economic useful life of 12 months or less, and that it treats such amounts as an expense on its AFS in accordance with such written accounting procedures.

Rotable and temporary spare parts

Both rotable and temporary spare parts are included as materials and supplies under Reg. sec. 1.162-3. The final repair regulations retain the definition of rotable spare parts as materials and supplies 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 defined as materials and supplies that are used temporarily until a new or repaired part can be installed and then are removed and stored for later installation.

Consistent with the 2011 temporary regulations, the final repair regulations provide a taxpayer with three methods for treating costs

related to rotable and temporary spare parts. In general, a taxpayer may deduct the cost of rotable and temporary spare parts in the tax year in which the taxpayer disposes of these parts. However, a taxpayer instead may elect to capitalize and depreciate the cost of such parts over the applicable recovery period, provided that the rotable or temporary spare part meets certain restrictions.

The third method -- provided in Reg. sec. 1.162-3(e), known as the optional method for rotable and temporary spare parts -- permits a taxpayer to:

- Deduct the cost to produce or acquire the part upon initial installation,
- Recognize in gross income the fair market value (FMV) of the part when removed from the unit of property, and include the FMV and cost to remove the part in the basis of the part,
- Add to the basis of the part any amount paid to repair, maintain, or improve the part,
- Deduct the cost of reinstallation and basis not previously deducted in the tax year in which the part is reinstalled, and
- Deduct any remaining amount of basis in the part in the tax year in which it is disposed of.

Observation: In light of the various alternative methods for treating rotable and temporary spare parts, a taxpayer should evaluate which method is optimal, taking into account the compliance requirements for each alternative method relative to the taxpayer's financial accounting treatment for such parts and the cash-flow advantages of each method (including, for example, whether bonus depreciation is applicable to such parts).

Standby emergency spare parts

In addition to rotable and temporary spare parts, the final repair regulations add "standby emergency spare parts" as a new category of materials and supplies.

Standby emergency spare parts are defined as materials and supplies that are acquired when particular machinery or equipment is acquired, set aside for use as replacements to avoid substantial operational time loss, located at or near the site or the related machinery, directly related to the machine or piece of equipment they serve, normally expensive, available only on special order and not readily available from a vendor or manufacturer, not subject to normal periodic replacement, not interchangeable in other machines or equipment, not acquired in quantity, and not repaired or reused.

The treatment of standby emergency spare parts is consistent with the treatment of rotable and temporary spare parts. However, unlike rotable and temporary spare parts, which are eligible for any of the three methods described above, standby emergency spare parts are not eligible for the third, optional method described above.

Observation: The preamble to the final repair regulations notes that the aforementioned definition of standby emergency spare parts generally is consistent with the definition of such parts contained in Rev. Rul. 81-185.

The takeaway

The final repair regulations provide significant changes to the treatment of materials and supplies, the de minimis rule, and spare parts relative to the 2011 temporary regulations. In addition, the final repair regulations provide taxpayers a variety of options, many in the form of an annual election, for the treatment of such property.

The IRS and Treasury Department should be commended for listening to, and addressing, the numerous comments and concerns taxpayers expressed with the 2011 temporary regulations and for providing more flexibility to accommodate taxpayers' differing needs and financial and tax accounting compliance limitations. Although uncertainty likely will remain in these highly subjective areas, the final repair regulations provide additional clarity that should make compliance with the final repair regulations easier with respect to the treatment of material and supplies, the de minimis rule, and spare parts.

On October 9, 2013, PwC hosted an in-depth webcast to analyze the impact of the final repair regulations and proposed disposition regulations.

A link to the archived replay can be found here: http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=688567&sessionid=1&key=10B22BFDF14B36E66B2BE404853A4A31

Let's talk

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