Guidance on accounting for assets: What companies need to know about single, multiple, and general asset accounts

January 7, 2013

In brief

The release in December 2011 of the temporary tangible property regulations (the temporary repairs regulations) has focused attention on the federal income tax accounting treatment of depreciable property. Although the effective date of those regulations has been delayed until 2014 (see discussion below of Notice 2012-73), taxpayers may "early adopt" the regulations in years prior to 2014, and should consider early adoption if beneficial. In particular, due to increased flexibility afforded by the regulations, companies now should consider whether to elect general asset account (GAA) treatment for their historic depreciable property.

In detail

Depreciation

Prior to 1981, depreciation was determined using "facts and circumstances," and component depreciation was permitted. Taxpayers could allocate the cost of a building to its basic component parts and recover the value of those components over separately assigned useful lives. In the Economic Recovery Tax Act of 1981, Congress eliminated component depreciation by enacting former section 168, Accelerated Cost Recovery System (ACRS), applicable to property placed in service between 1981 and 1986.

According to the Joint Committee on Taxation (JCT) explanation of the 1981 Act, "components included the basic building shell, wiring, plumbing and heating systems, roof, and other identifiable components." As the explanation stated, "[t]he recovery period of a building begins when the building is placed in service. If a component part is placed in service before the building as a whole is placed in service, the recovery period of the component commences when the building is placed in service." The explanation added that "Congress did not intend a retirement of a structural component of the building to be a disposition requiring recognition of gain or loss." Thus, Congress intended the elimination of separate depreciation of components to extend to dispositions of components.

The Tax Reform Act of 1986 enacted current section 168, the Modified Accelerated Cost Recovery System (MACRS). Under MACRS, taxpayers recover the cost of the tangible depreciable property using a defined recovery period (as provided in Rev. Proc. 87-56), the applicable depreciation method, and the applicable convention. MACRS applies to assets placed in service after 1986. The JCT explanation of the 1986 Act states that "[t]he Act preserves the prohibition against use of the component method of depreciation.

Temporary repairs regulations

The IRS in December 2011 published the temporary repairs regulations (in temporary and proposed form) under section 263(a) addressing the deduction and capitalization of expenditures related to tangible property. Initially, these regulations were to be effective for tax years beginning on or after January 1, 2012. Repairs regulations have been a priority guidance project for approximately eight years, having been announced in 2004 in an Advance Notice of Proposed Rule Making, proposed in August 2006, and reproposed in March 2008. The temporary repairs regulations differ significantly in many respects from prior law as well as from the 2006 and 2008 proposed versions of these regulations.

In addition to the rules discussed below on MACRS property, the temporary repairs regulations modified prior rules defining what expenditures must be capitalized as an improvement to tangible property. In particular, taxpayers must capitalize expenditures that result in a "restoration" of tangible property.

The definition of restorations under Reg. sec. 1.263(a)-3T(i) includes amounts paid:

- for replacement of a component of a unit of property if the taxpayer has properly deducted a loss for that component (other than a casualty loss under Reg. sec. 1.165-7);
- for replacement of a component of a unit of property if the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- for repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165;
- to return the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and no longer is functional for its intended use;
- that result in rebuilding of the unit of property to a like-new condition after the end of its class life; or
- for replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property.

The temporary repairs regulations define the unit of property for a building as each building and its structural components. However, the regulations further require costs to be capitalized if the costs incurred result in an improvement to the building structure, or to any of the building systems designated by the temporary repairs regulations, including the heating, ventilation and air conditioning systems, plumbing systems, electrical systems, elevators, escalators, fire protection and alarm systems, security systems, and gas distribution systems.

Notice 2012-73

The IRS in late 2012 issued Notice 2012-73 (the Notice), announcing that final regulations regarding the deduction and capitalization of expenditures related to tangible property (the final repairs regulations) are expected to be released in 2013. The Notice explains that the IRS anticipates that the final repairs regulations will contain changes from the temporary repairs regulations issued in December 2011.

The Notice further explains that the final repairs regulations will be effective for tax years beginning on or after January 1, 2014, and that taxpayers will be permitted to apply either the temporary repairs regulations (the effective date of which has been changed to tax years beginning on or after January 1, 2014), or the final repairs regulations, for tax years beginning on or after January 1, 2012, and before the applicability date of the final regulations. (For further discussion of Notice 2012-73, see WNTS Insight, "IRS formally delays effective date of the temporary repairs regulations," December 14, 2012.)

Accounting for MACRS property under the temporary repairs regulations

Default rules

Under the default rules, taxpayers account for MACRS property using either a single asset account (SAA) or a multiple asset account (MAA). For SAA, taxpayers account for depreciation and dispositions of each asset separately. SAA treatment is adopted by filing a return; no special statement is required.

Under the regulations, SAA treatment is *required*:

- when an asset is used for both business and personal purposes;
- when an asset is placed in service and disposed of in the same year;
- in the year of disposition for an asset previously accounted for in

an MAA or a component of a larger asset; and

- when an asset is removed from a GAA (discussed below) because of a qualifying disposition, substantial distortion of foreign vs. US income, an abusive transaction, a recapture event, or a change in the business or income-producing use percentage for the asset.

Taxpayers also may choose to account for their MACRS property using MAA. MAA treatment is a non-elective method of accounting. An MAA is an informal grouping of assets where no affirmative election or statement is required. MAA is not available for assets in GAAs and assets that must be treated as single assets.

Assets grouped into MAAs must have the same depreciation method, recovery period, placed-in-service year, and convention. Assets in an MAA also must be grouped with similar assets:

- bonus depreciation assets (must be the same percentage -- for example, 30, 50, or 100 percent);
- assets for which the taxpayer is not taking bonus depreciation;
- assets for which the taxpayer is not using the optional depreciation tables in Rev. Proc. 87-57;
- listed passenger autos;
- all other listed property; and
- mass assets to be identified by mortality dispersion table upon disposition.

Taxpayers may set up as many or as few MAA pools as desired that meet these criteria. Assets in an MAA are depreciated under MACRS as a single asset.

Dispositions from an MAA

While assets accounted for using an SAA are specifically identified for dispositions, the temporary repairs regulations provide a variety of methods for identifying dispositions from an MAA. Specifically, an asset is to be removed from the MAA and placed in an SAA on the first day of the tax year of disposition. The taxpayer then must stop depreciating the asset and recognize gain or loss on adjusted basis.

The taxpayer may identify which asset was removed from the MAA using any of the following methods (as applicable):

- specific identification;
- first-in, first-out (FIFO) method;
- modified FIFO method under which the taxpayer treats the asset disposed of as being from the MAA with the earliest placed in service year that has assets with the same recovery period of the asset disposed of and with the same unadjusted depreciable basis of the asset disposed of;
- mortality dispersion table if the assets in the MAA are mass assets; or
- any other method the Secretary may designate.

The last-in, first-out (LIFO) method expressly is not allowed for dispositions from MAAs.

Special rule for components

Under an SAA or MAA, taxpayers must account for dispositions of building components. Specifically, for purposes of identifying the asset disposed of, each building (not including its structural components) is the asset. Further, in identifying the asset disposed of, each structural component of a building is the asset. For example, if a taxpayer owns an office building with four elevators and replaces one elevator, then the replaced elevator is the asset disposed of. Depreciation of the replaced elevator ceases at the time of its retirement, and the taxpayer recognizes a loss upon its retirement.

For personal property -- for example, an aircraft engine -- taxpayers may choose to account for component dispositions separately from the larger unit of property only if the taxpayer consistently accounts for dispositions in this manner.

Observations

Under the temporary repairs regulations, taxpayers must account for dispositions of components of buildings, including historic dispositions. Rev. Proc. 2012-20 confirms that the IRS expects taxpayers to account for historic partial dispositions of real property using a section 481(a) adjustment. This requirement may result in a number of subsequent expenditures having to be capitalized as restorations that were previously deducted as repairs.

Further, if taxpayers do not capture historic dispositions or elect GAA treatment (described below), they run the risk of creating "trapped basis," meaning (1) the cost was not previously recovered and (2) the statute of limitations for the disposition year has closed.

General asset accounts

Section 168(i)(4) provides that "[u]nder regulations, a taxpayer may maintain 1 or more GAAs for any property to which this section applies. Except as provided in regulations, all proceeds realized on any disposition of property in a GAA shall be included in income as ordinary income."

Reg. sec. 1.168(i)-1, which existed prior to the issuance of the temporary repairs regulations, provided taxpayers with guidance on how to account for assets elected to be included in GAAs, as well as how to account for dispositions of assets in GAAs. However, such rules were rigid, and few taxpayers chose to elect to use GAAs in accounting for MACRS property. The temporary repairs regulations revise and broaden these rules to provide taxpayers more flexibility for assets included in GAAs, as well as to align the GAA rules with many of the rules provided for MAAs.

Changes under the temporary repairs regulations

Under the temporary repairs regulations, inclusion of property in a GAA still is elective. Taxpayers may apply GAA treatment to single assets or groups of assets. GAA treatment is not available for assets placed in service and disposed of in the same year, or for assets used for any personal activity.

The election is made in the manner provided for on Form 4562 and its instructions in the year the asset or group of assets is placed in service. The election generally is irrevocable and is binding for the year in which the election is made as well as for subsequent tax years.

Observation: Rev. Proc. 2012-20 permits taxpayers to make a "late" GAA election for property placed in service in prior years by filing Form 3115. This late election is available only for a timely filed Form 3115 for the first or second tax year beginning on or after January 1, 2012.

Similar to the MAA rules, the assets grouped into GAAs must have the same depreciation method, recovery period, year placed in service, and convention (same month or quarter if mid-month or mid-quarter applies), and assets must be grouped with similar assets (see MAA discussion in "Default rule" section above). Assets in a GAA are depreciated under MACRS as a single asset.

Dispositions

As a general rule, when a taxpayer disposes of property from a GAA, the taxpayer continues to depreciate the asset upon disposition. The taxpayer recognizes any gain as ordinary income in the amount of any proceeds. There is no recognition of loss -- the asset is treated as having zero basis immediately before the loss, and depreciation of the GAA continues.

If a taxpayer has a qualifying disposition, disposes of all assets in a GAA, or disposes of the last asset in the account, then the taxpayer may elect to recognize loss on the disposition by electing out of GAA treatment. In such a case, similar to dispositions from an MAA, the taxpayer will identify the assets disposed using one of the following methods:

- specific identification;
- FIFO method;
- modified FIFO method under which the taxpayer treats the asset disposed of as being from the MAA with the earliest placed-in-service year that has assets with the same recovery period of the asset disposed or and with the same unadjusted depreciable basis of the asset disposed of;
- mortality dispersion table if mass asset (discussed below); or
- any other method the Secretary may designate.

As with MAAs, the LIFO method expressly is not allowed for dispositions from GAAs.

Observations

As provided in the temporary repairs regulations, a qualifying disposition is any disposition except a disposition that involves all the assets or the last asset in a GAA, a nonrecognition transfer, a like-kind exchange or involuntary conversion, a technical termination of a partnership, or an abusive transaction. The prior definition of a qualifying disposition was not as flexible as the updated definition, which allows for almost all types of dispositions to be considered qualified.

If a taxpayer makes a GAA election, then that election resolves the trapped basis issue discussed above.

When disposing of assets from GAAs, taxpayers should keep the restoration rules in mind because taxpayers have a choice between (1) electing a qualifying disposition to take a loss, and then capitalizing the replacement as a restoration, or (2) deducting the replacement (if otherwise permissible under the temporary repairs regulations), continuing to depreciate the disposed asset, and forgoing the loss.

Actions to consider

In light of the increased flexibility afforded by the temporary repairs regulations, taxpayers should consider whether to elect GAA treatment retroactively for their historic depreciable property, and whether to elect annually GAA treatment for new fixed asset additions.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Federal Tax Services

Sara Logan, *Washington, DC*
(202) 414-1417
sara.l.logan@us.pwc.com