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Tangible Property Regulations

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Agenda

- Why is this important?
- Review of Tangible Property Regulations
- What's Next - Adoption
- Common Reactions

Why Is This Important?

- TPRs apply to **ALL** taxpayers who acquire, produce, or improve tangible property

  T.D. 9564: Tangible Property Capitalization Guidance:

  "The Temporary Regulations will affect all taxpayers that acquire, produce, or improve tangible property."

- **Requires significant lead time to plan for and implement**

- IRS anticipates that every taxpayer in the country will file accounting method changes to be in compliance

Tangible Property Regulations - Overview

- The new regulations address the following issues:
  - Materials and Supplies *(cost to acquire/produce)*
  - De Minimis Rule *(cost to acquire/produce)*
  - Improvements / Repairs / Routine Maintenance safe harbor
  - Dispositions / General Asset Accounts

- For taxpayers that have historically followed book capitalization policies for <u>repairs</u>, these regulations generally provide <u>more favorable tax methods</u>

Tangible Property Regulations – As of Today!

- Temporary Regulations are generally effective for *taxable years beginning on or after January 1, 2012**
- "Beginning of time" concept unless provided otherwise (Supplies/De Minimis)
- Revenue Procedures 2012-19 and Rev. Proc. 2012-20 provide **19 individual automatic method changes** that need to be assessed for compliance with the new regulations
  - Calendar year companies may adopt in 2012 or 2013*
  - Fiscal year taxpayer's may adopt for the first year beginning after 2012 or 2013*
  - Scope limitations waived even if prior repair issue is under examination
  - LB&I Directive provides audit protection for certain issues if filed in 2012 or 2013*

**** See Notice 2012-73***

Notice 2012-73 – Expected Changes

- Treasury expects to amend the Temporary Regulations to make effective for tax years beginning *on or after January 1, 2014*
- Treasury expects that Final Regulations (to be issued in 2013) will be effective for tax years beginning *on or after January 1, 2014*
- Taxpayers *may apply* the Temporary and Final Regulations to tax years beginning on *or after January 1, 2012*
- Temporary Regulations may be revised in the following areas:
  - De Minimis Rule (transaction vs. aggregate)
  - Dispositions (GAA elections)
  - Safe Harbor for Routine Maintenance (“time the UoP is placed into service”)

Questions?

Costs to Acquire or Produce

Costs to Acquire or Produce Tangible Property

Temp. Reg. 1.263(a)-2T(d)(1):

"Except as provided in paragraph (g) of this section (providing the ***de minimis rule***) and in §1.162-3T (relating to ***materials and supplies***), a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property"

What Does This Mean?

General rule requires all costs incurred to <u>acquire or produce</u> tangible property to be capitalized

- *Repairs of tangible property are analyzed under the Improvement/Repair standards*

<u>Two ways to avoid capitalization of costs to acquire or produce</u>:

- ➢ Cost qualifies as a "***material or supply***" as defined in the Temp Regs, <u>or</u>
- ➢ Cost was expensed for book purposes (consistent with book accounting policy) and aggregate of all costs for the year do not exceed the "***de minimis***" ceiling.

- *What if I have tangible property costs left over after bucketing between materials & supplies and de minimis?*
  - ➢ Tax only asset that must be depreciated (based on business activity)

Illustration: Non-Repair Tangible Property Costs

Tangible property costs **expensed for book**	$1,000,000
Materials & Supplies (*expense for tax*)	($300,000)
De Minimis Ceiling (*expense for tax*)	($150,000)
Tangible property costs **capitalized for tax**	$550,000

A material and supply is tangible property used or consumed in the taxpayer’s operations that is <u>not inventory</u> and is—

- Component acquired to maintain, repair, or improve a UoP
- Fuel, lubricants, water, or similar items reasonably expected to be consumed in ≤ 12 months
- A UoP with economic useful life of ≤ 12 months beginning when used or consumed in operations
- A UoP with acquisition or production cost of ≤ $100
- Property identified in published guidance

Materials and Supplies

- Incidental = deductible when purchased
  - Incidental if no record of consumption or no physical inventories are kept
- Non-incidental = deductible when used or consumed
- Optional election to **capitalize and depreciate** materials and supplies
- Special rules for rotable and temporary spare parts
  - General rule is deduct when consumed (disposed of),
  - Capitalize and depreciate, or
  - Adopt the new “optional” method

De Minimis Rule – *"Book Conformity"*

Requirements

- Applicable Financial Statement ("AFS")
- Written capitalization policy *(e.g. <$1,000)*
- Expense in AFS according to written policy

Deduction limited to *greater* of:

- 0.1% of tax gross receipts, **or**
- 2% of depreciation on AFS

****Notice 2012-73****

De Minimis Rule – Example

Assume the taxpayer has an AFS and a written policy at the beginning of Year 1, under which it expenses amounts paid for property costing less than $500.

In Year 1, the taxpayer pays $160,000 to purchase 400 computers at $400 each. Each computer is not a material or supply.

Assume that for its Year 1 taxable year, the taxpayer has tax gross receipts of $125M and book depreciation/amortization of $7M.

De Minimis Rule – Example (cont.)

- To be eligible for the de minimis rule, the total aggregate amounts paid and not capitalized by the taxpayer must be less than or equal to the greater of $125,000 (0.1% of its total gross receipts of $125M) or **$140,000** (2% of its total book depreciation/amortization $7M).

- Because the taxpayer pays $160,000 for the computers and this amount exceeds $140,000, the general rule provides that it may not apply the de minimis rule to any of the amounts paid for the 400 computers.

De Minimis Rule – Example (cont.)

- However, if it makes <u>an election to capitalize $20,000</u>, the amounts paid to acquire 50 of the 400 computers purchased in Year 1, it would <u>not be required to capitalize the amounts paid to acquire the 350 computers in Year 1</u>**.**

Must capitalize and keep separate tax records to track depreciation for the 50 computers that were expensed for book

Example - What If We Do Nothing?

De minimis Threshold			
Total Tax Return Gross Receipts		5,509,000,000	
Total AFS Depreciation/Amortization		195,000,000	
De minimis threshold equal to the greater of:			
Gross Receipts Limitation	0.1%	***5,509,000***	(a)
Book Depr/Amort Limitation	2%	***3,900,000***	

Tax Deduction Summary			
	Form 1120		
Line 14	Repairs and Maintenance	17,000,000	
Line 26	Misc exp	35,000,000	
Line 26	Corp Exp	3,000,000	
Line 26	Samples	11,000,000	
Line 26	Office Supplies	6,000,000	
Sch A line 5	Office Supplies	1,500,000	
Sch A line 5	Packing and Shipping supplies	6,000,000	
Sch A line 5	Manufacturing supplies	23,000,000	
Sch A line 5	Small tools/dies	6,000,000	
Sch A line 5	Repairs and Maintenance	45,000,000	
Schedule M	Tax Repairs and Maintenance	1,500,000	
		155,000,000	(b)

Exposure Analysis - Year 1			
De Minimis Threshold	$	5,509,000	(a)
Tangible Property Costs Incurred		155,000,000	(b)
Potential Reclass to Capital Asset		**149,491,000**	
50% Bonus Depreciation for 2012		(74,745,500)	
Potential Exposure - Gross		74,745,500	
		35%	
Potential Exposure - Net (Yr 1)	$	26,160,925	(c)

Exposure Analysis - Years 2 to 5 (assumes no increase in sales/expenses)			
De Minimis Threshold	$	5,509,000	(a)
Tangible Property Costs Incurred		155,000,000	(b)
Potential Reclass to Capital Asset		**149,491,000**	
Assume 0% Bonus Depreciation for 2013 - 2016		-	
Potential Exposure - Gross		149,491,000	
		35%	
Potential Exposure - Net (Single Year)	$	52,321,850	
4 Year Estimate (Yrs 2 - 5)		4	
Potential Exposure - Net (Yrs 2-5)	$	209,287,400	(c)

Total Estimated Exposure over 5 Years	***$***	***235,448,325***	∑ (c)

Food for Thought - Materials and Supplies/De Minimis Rule

- What is your book capitalization policy for tangible property costs (TPC)?
  - Do you know where all of your expensed TPC are recorded?
    - E.g. uniforms, cleaning services, telephones, advertising, training
- What is included in materials and supplies (as defined under the temporary regulations) for book purposes?
  - In what g/l accounts are materials and supplies recorded?
  - Are any materials and supply costs capitalized for book purposes?
  - Is information available to determine incidental/non-incidental?
- Do you have a process to determine which book TPC are material and supplies and which are subject to the de minimis ceiling?

Questions?

Costs to Improve

Amounts Paid to Improve Tangible Property

Determine the unit of property

Apply the improvement standards

Consider the routine maintenance safe harbor

Unit of Property (UoP) - Building

Unit of Property

- Each building and its structural components are a unit of property

Improvement standards applied to

- **Building systems:**
  - heating, ventilation, and air conditioning systems (HVAC)
  - plumbing systems
  - electrical systems
  - all escalators;
  - all elevators
  - fire protection and alarm systems
  - security systems
  - gas distribution systems
  - other structural components identified in published guidance
- **Building structure**, which is defined as the building and its structural components (other than the sub-systems above)

Unit of Property – Example

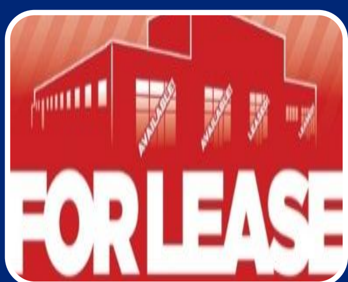
Building systems

- X owns a building that it uses in its retail business. The building contains **two elevator banks** in different locations in its building. Each elevator bank contains three elevators. X pays an amount for labor and materials for work performed on the elevators.
- Under the UoP rules, X must treat the **building and its structural components** as a single unit of property.
- All of the elevators, including all their components, ***comprise a building system***.
- Therefore, if an amount paid by X for work on the elevators ***results in an improvement to the entire elevator system, X must treat these amounts as an improvement to the building (i.e. capitalize)***

Unit of Property

Plant Property

- **<u>Functional interdependence</u>** is relevant
- Discrete and major function standard must be applied



Leased Property

- Each building and its structural components (*<u>lessor</u>*) or the portion of each building subject to the lease and the structural components associated with the leased portion (*<u>lessee</u>*)

- Improvement standards are applied to the portion of the building & building systems subject to the lease *(<u>lessee</u>)*

Other Property

- Functional Interdependence
- Facts & circumstances

UoP – Plant Property

- Functionally interdependent machinery or equipment used to perform an *industrial process*

- Further divided into smaller units comprised of each component that *performs a discrete and major function* or operation within the functionally interdependent machinery or equipment

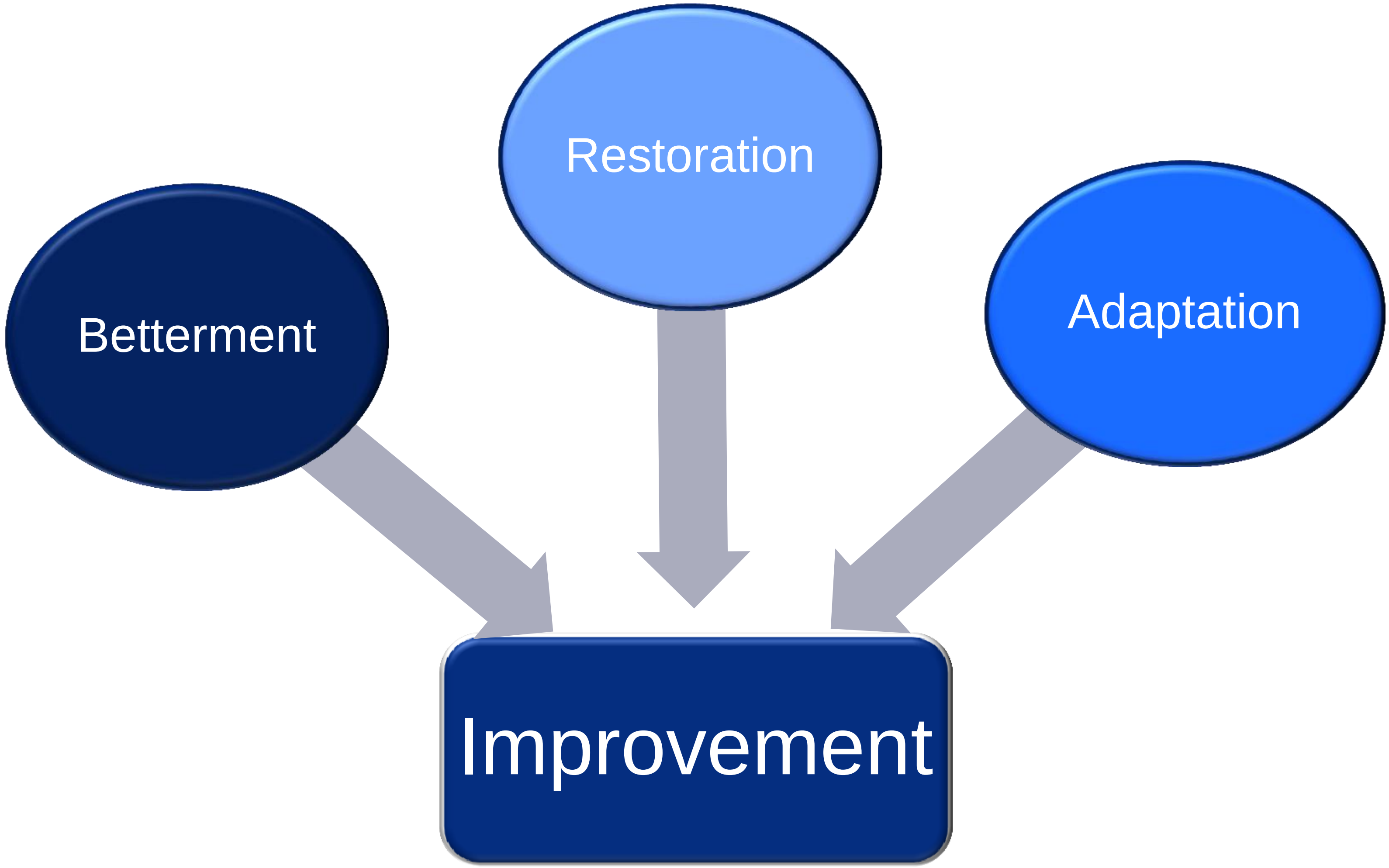
- **Example 1** – Uniform and linen rental business with two separate laundry lines
  - Sorter, Boiler, Washer, Dryer, Ironer. Folder, Waste water treatment system
  - Industrial process

- **Example 2** – Restaurant with “assembly line-like” tortilla making equipment
  - Not an industrial process

Food for Thought - Determining the Unit of Property

- What are your current tax units of property for improvement purposes?
  - Do you treat the **building structure** and **building systems** as separate UoP?
  - Do you treat industrial **plant property** components that perform discrete and major functions as separate UoP?
  - What is your UoP for **leased property**?
- Does your fixed asset system identify separate UoP **for tax purposes**?
- Who determines/records UoP for tax purposes?

Improvement Standards



Betterment

An amount paid for a betterment **must be capitalized**

A betterment is an expenditure that—

- Corrects a *material defect* existing prior to the taxpayer's acquisition of the UoP or one that arose during the production of the UoP;
- Results in a *material addition* (e.g., physical enlargement, expansion or extension) to the UoP; **or**
- Results in a *material increase* in capacity, strength, productivity, efficiency, quality, or output of the UoP

Betterment (cont.)

- Appropriate comparison is between condition of UoP after repair with condition of UoP immediately before the event necessitating the repair
  - For normal wear and tear, look to immediately prior to last correction of wear and tear
- Whether expenditure is “material” based on facts and circumstances
  - Purpose of expenditure
  - Physical nature of work performed
  - Affect of expenditure on the UoP
  - Treatment on taxpayer’s AFS

Betterment - Examples

Improvement (capitalize)	Repair (deduct)
• Costs to refresh retail stores that **substantially remodel and upgrade** the stores • Costs to disassemble, move, reconfigure and add components to manufacturing equipment that **increase capacity** of equipment • Costs to replace wooden shingles **with lightweight, maintenance-free shingles**	• Costs to refresh retail stores that keep buildings in **ordinary efficient operating condition** • Costs to **correct seepage** of oil in meat processing plant • Costs to replace wooden shingles **with new wooden shingles**

Restoration

- An amount paid for a restoration **must be capitalized**
- A restoration is an expenditure that—
  - Replaces a component deducted as a loss
  - Replaces a component and basis adjusted for sale or exchange
  - Repairs a component after a casualty, if basis adjusted
  - Returns a UoP to **operating condition** if in a state of **nonfunctional disrepair**
  - **Rebuilds** the UoP to like-new condition **after the end of class life**
  - **Replaces a major component** or substantial structural part of the UoP
    - Large portion of the physical structure **or** performs a discrete and critical function

Restoration - Examples

Improvement (capitalize)	Repair (deduct)
• Freight car rebuilt to like-new condition **after** end of class life • 200 of 300 windows • Large portion of decking, insulation and membrane of roof	• Freight car rebuilt to like-new condition **before** end of class life • 30 of 300 windows • Waterproof membrane of factory roof

Adaptation

Adaptation:

- **Modification of a unit of property that is not consistent with the taxpayer's intended ordinary use of the unit of property at the time the property was placed in service**

Example – Manufacturing facility converted into a showroom for products

Food for Thought - Is an Expenditure an Improvement?

- What is your book capitalization policy?
  - Who determines (and based on what criteria) whether an expenditure is a deductible repair or a capitalizable improvement?
  - **How do these criteria align with the temporary regulation definition of betterment, restoration, adaption**?
- Do your systems allow you to track whether there has been a **basis recovery event?**
- Do you have a mechanism to determine whether an expenditure is to rebuild a UoP to a **like-new condition** or to **replace a major component**?

Routine Maintenance Safe Harbor

Amount paid is deemed to *not* improve the unit of property if it is for the *recurring activities* that a taxpayer expects to perform as a result of the taxpayer's use of the UoP to keep the unit of property in its *ordinarily efficient operating condition*

- Safe harbor does *not* apply to buildings or structural components of buildings (or building systems)
- Routine maintenance is activities that the taxpayer reasonably expects (**at the time the property is placed in service***) to perform more than once during the ADS class life of the UoP

*** Notice 2012-73**

Routine Maintenance Safe Harbor Activities

- <u>Inspection</u>, <u>cleaning</u>, and <u>testing</u> of the unit of property, **and**

- The <u>replacement of parts</u> of the unit of property with **comparable** and commercially available and **reasonable** replacement parts.

Examples - Routine Maintenance Safe Harbor

- Aircraft with 12-year ADS class life
  - Engine shop visit performed in year 5 and year 10 on aircraft engine
  - Engine shop visit performed in year 15 on original aircraft engine
- Lined containers used in production process w/12-year ADS class life
  - Lining is <u>substantial structural</u> part of container
  - Replacement of container linings in years 4, 7, 9 and 12
- Irrigation canals with 20-year ADS class life
  - Expects to perform major maintenance every 3 years to keep in ordinarily efficient operating condition
  - Does not perform the required maintenance until year 6 when the canals have fallen into a state of nonfunctional disrepair; repairs return to ordinary operating condition

Food for Thought - Routine Maintenance Safe Harbor

- How does your company capture information regarding costs that would be eligible for the **routine maintenance safe harbor**? Who makes this decision?
- Can you determine whether an activity is reasonably **expected to occur more than once** during the ADS class life?
  - Do you have manufacturers' suggested maintenance information, industry practice, treatment on applicable financial statement, historic treatment for similar UoP?
  - How can you track and record this information?
  - What will the Final Regulations require (per Notice 2012-73)?

Questions?

Dispositions and General Asset Accounts

Dispositions

- **Must** recognize dispositions of components of buildings
  - Consider implications for **restoration rules**
  - Consider electing General Asset Account
- **May** recognize dispositions of components of personal property
  - Must apply componentization consistently
- Dispositions of MACRS property include—
  - Sale or exchange
  - Retirement
  - Physical abandonment
  - Destruction (including casualty)
  - Transfer to supplies, scrap, or similar account
  - Involuntary conversion
  - Retirement of a structural component of a building

General Asset Accounts ("GAA")

- Election to treat one or more assets in a single GAA
  - Each account can only include assets with same MACRS recovery period, convention, and placed in service year
  - Cannot combine assets for which bonus depreciation was claimed with those for which bonus not claimed
  - Can elect for a single building

- No gain or loss on disposition of an asset or component of an asset in general asset account until all assets/components disposed
  - Election available to treat an asset/component as a separate asset ("Qualifying Dispositions")

Election provides flexibility in applying the restoration improvement standard

Example – Single Asset Account ("SAA") v. GAA

Co. A discovers leaks in roof of office building and replaces the roof

SAA	GAA – general	GAA – qualifying disposition election
Stop depreciation of basis in original roof	Continue depreciation of basis in original roof	Stop depreciation of basis in original roof
Recognize loss	No loss recognition	Recognize loss
Capitalize and depreciate cost of new roof as a default Restoration under Improvement rules	*Improvement* - Capitalize and depreciate cost of new roof if a Betterment or Restoration ***or*** *Repair* – Deduct cost of new roof if not an improvement	Capitalize and depreciate cost of new roof as a default Restoration under Improvement rules

Example

- In June 2012, ABC, a calendar year taxpayer, decides to replace the roof on its manufacturing building, because the roof is leaking. The building was placed in service in 2000.
- ABC's tax adjusted basis in the building is $150M
- ABC believes **$4M** of adjusted basis is allocable to the portion of the roof to be replaced.
- The cost to replace the roof is **$7M**.
  - What happens if the cost is an improvement under SAA? GAA?
  - What happens if the cost is otherwise a repair under SAA? GAA?

Method Changes and Common Elections

Method Change Rules - Rev. Procs. 2012-19 and 2012-20

- Automatic method changes under Rev. Proc. 2011-14
- Scope limitations in Section 4.02 of Rev. Proc. 2011-14 waived for first and second taxable year beginning after 12/31/2011
  - Most changes made with IRC § 481(a) adjustment
  - Some changes made with modified IRC § 481(a) adjustment
    - May use **statistical sampling** as provided in Rev. Proc. 2011-42 for certain methods
  - Some made on cut-off or modified cut-off basis
    - Special rules for concurrent changes to comply with IRC § 263A

Method Changes

Rev. Proc. 2012-19	Rev. Proc. 2012-20
• **Repairs/Unit of Property** • **Improvements** • **Routine maintenance safe harbor** • Optional regulatory method • **Incidental supplies** • **Non-incidental supplies** • Rotable spare parts (2) • **De minimis rule** • Dealer facilitative sales costs • Non-dealer facilitative sales costs • Real property investigatory costs • **Capitalize costs to acquire/produce property**	• Depreciation/amortization of leasehold improvements • Changes within single, multiple, or general asset accounts • Dispositions of buildings or structural components • Dispositions of tangible depreciable assets (other than buildings) • **Late general asset account elections**

Common Elections

Utilize various elections to increase or decrease taxable income:

- Treat materials & supplies under de minimis rule
- Capitalize and depreciate materials and supplies, including separate election for rotable spare parts
- Capitalize and depreciate de minimis costs
- Capitalize employee compensation and overhead incurred in acquiring or producing tangible property
- Use General Asset Accounting (“GAA”), with additional election options:
  - To terminate GAA when all or the last asset in account is disposed
  - To determine the gain, loss or other deduction for disposition of specifically identified component (“Qualifying Disposition”)

What’s Next - Adoption

Three Phase Process to Adoption

Gap-Analysis → Detailed Analysis → Design & Execute

Phase 1 – Gap-Analysis

- Preliminary focus on areas of opportunity and potential compliance items that require action
- Establish an understanding of existing policies and processes, as well as system configurations for high impact areas given Company's business
- Develop an efficient and practical work plan to arrive at a solution with the least impact on tax department resources.

Phase 2 – Detailed Analysis

- Gather required documentation and data
- Conduct analysis for each work stream identified in Phase 1 based on an understanding of the current financial statement policies and related tax policies
- Interview accounting, information technology and tax personnel as appropriate

Phase 3 – Design & Execution

- Establish, document and execute revised tax policies in compliance with temporary regulations
- Provide filings (Form 3115s), computational analyses, technical memoranda, and work papers in support of tax adjustments in addition to establishment of appropriate procedures and processes

What Is A Gap Analysis?

- A review of a taxpayer's historic capitalization decisions within the context of the TPRs, including the following:
  - Recommendations regarding which of the potential *19 method of accounting changes* will need to be filed
  - Recommendations regarding the *timing* of the filling of the changes in method of accounting
  - Estimate the *benefits/exposure* of adopting the new guidance
  - Recommendations and best practices for consideration with the *ERP system*

Gap Analysis

Information Gathering & Requests

- Review information regarding historical capital spend.
- Request contact information for personnel in accounting, IT, fixed assets, and tax.
- Request and obtain consolidated trial balances, supporting work papers, transaction details, current Schedule M work papers, and capitalization policies and procedures
- Identify the **high impact areas** and establish the most efficient and practical workplan to arrive at a solution with the least impact on resources

Gap Analysis

Information Gathering & Requests → **Analysis** → Document

Analysis

- Conduct **interviews** to better understand historical treatment of items included within the TPRs.
- Review current **financial statement policies** related to capitalization thresholds, materials & supplies, etc..
- Review all requested workpapers to determine the **historical treatment** for book and tax.
- Understand how previously determined **units of property** for financial statement and federal income tax purposes fit within the context of repair & maintenance expenditures.
- Understand the historical methodology for **disposing of building-related** components.
- Determine applicability of General Asset Account elections.
- Review any previously completed fixed asset studies to identify the impacts of the TPRs.
- Document applicability of each of the method changes included within the TPRs

Gap Analysis

Document

- A comprehensive package that summarizes all the accounting method changes included within the transitional guidance and other recommendations.
- Explanation regarding the application of each change in method of accounting
- A list of changes in method of accounting that are **required to be filed** to be in compliance with the Regulations.
- A timeline for filing the required changes in method of accounting
- Quantified benefit and exposure of the accounting methods including **estimated I.R.C. Section 481(a) adjustments.**

Common Reactions

"Not Now"

- Can cherry pick favorable method changes for 2012 and delay unfavorable to at least 2014
- Gap analysis provides a roadmap for planning; implementation can be executed when desired under the Regs

"Doesn't apply to us"

- Apply to everyone – assume almost all companies will need to file **at least 6** of the changes

"We follow book"

- Book conformity not currently an option (other than de minimis)
- To deduct book repairs you may need Routine Maintenance Rule (change)

"We'll let the IRS prove we're on impermissible methods"

- Burden of proof is on taxpayer to support deductions for tangible property costs and repairs
- IRS expectations for documentation (IDRs) likely to become more robust after first year of exam experience

"We didn't do a repair method change in prior years"

- Temp Regs also include changes related to supplies, de minimis (see line 26 on tax return)

"We are going to handle ourselves"

- Experience – Invaluable

Questions?

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