

White Paper

# Tangible Asset Repair Analysis

Understanding the impact of IRS regulation changes for tangible property and repairs

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**Years of jousting and contention have been settled. The Internal Revenue Service recently finalized regulations related to tangible property and repairs. As with many new interpretations, taxpayers now have a treasure trove of opportunities as well as a minefield of potential pitfalls.**

## **Overview**

The long-fought battle over accounting for tangible property purchases, repairs, and overall policies has ended in hundreds of pages of regulations that yield financial opportunity and much needed direction for taxpayers. New definitions provide guidance on the capitalization of an expense and situations where the expenditure is a period expense.

Saavy business owners can utilize the new regulations to uncover a number of financial opportunities. Using best practices to analyze fixed asset and affiliated accounts, such as repairs and maintenance, is the key to these opportunities.

## **Summary of New Rules**

Prior to the new regulations, the standards used to determine whether an expense could be deducted as a repair versus being capitalized and depreciated created considerable controversy between taxpayers and the IRS. After a lengthy process, final regulations are now in place and required with 2014 income tax returns. The new rules impact tax accounting for the following items:

- ◆ Materials and supplies
- ◆ Improvements
- ◆ Repairs and maintenance
- ◆ Asset dispositions
- ◆ Acquisition and production costs

Taxpayers have a unique opportunity and obligation included in their 2014 tax filing. Filers are able to capture tax benefits from application of the new rules to current and prior tax periods. The benefits will be recognized in the form of additional deductions on 2014 tax returns. The new rules also allow for a series of elections and procedures that further enhance the benefits for 2014 and forward.

## **De Minimis Safe Harbor Election**

Prior to the new regulation, there was debate over whether amounts paid to acquire or produce a unit of real or

personal property were period expenses or were to be capitalized. The former rule generally required capitalization of any property acquisition expense. The new rules now allow a *de minimis* safe harbor election.

The de minimis election allows deductions up to \$5,000 (per invoice) of the amount paid for personal property. That amount, however, is limited to \$500 (per invoice) if the taxpayer does not have an audited financial statement. **This election and other administrative requirements must be included with the 2014 tax return.**

In addition to the safe harbor, the election provides much needed guidance and offers a great opportunity to taxpayers.

### **Example**

*In Year 1, TW Corporation purchases 10 printers at \$250 each as detailed out on the invoice for a total cost of \$2,500. The company does not have an applicable financial statement (AFS). They have accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than \$500, and the company treats the amounts paid for the printers as an expense on its books and records. Therefore, the amounts paid for the printers meet the requirements for the de minimis safe harbor. If TW elects to apply the de minimis safe harbor, it may deduct these amounts in Year 1.*

## **Materials & Supplies**

Amounts paid to acquire or produce materials, supplies, and spare parts are generally deductible in the year in which they are used or consumed. Amounts paid to acquire or produce incidental materials and supplies (not tracked) can generally be deducted in the taxable year in which these amounts are purchased. This includes any tangible property that is used or consumed in the taxpayer's operations that is not inventory and that:

- ◆ is a component acquired to maintain, repair, or improve the property,
- ◆ consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less,
- ◆ has an economic useful life of 12 months or less, or
- ◆ has an acquisition or production cost of \$200 or less.

Fortunately, the government has acknowledged that it does not intend for this *de minimis* safe harbor to prevent a taxpayer from reaching an agreement with IRS examining agents to use a higher dollar threshold for items it writes off.

### **Example**

*In Year 1, TW Corporation pays \$500 to purchase one box of 10 toner cartridges to use as needed for the company's printers. In Year 1, TW's employees place eight of the toner cartridges in printers in the office, and store the remaining two cartridges for use in a subsequent taxable year. The toner cartridges are materials and supplies because even though purchased in one box costing more than \$200, the allocable cost of each unit of property equals \$50. Therefore, the \$400 paid by the company for eight of the cartridges is deductible in Year 1, the taxable year in which the company first uses each of those cartridges. The amounts paid by TW for each of the remaining two cartridges (\$50 each) are deductible in the later taxable year in which each cartridge is used in the business, unless the de minimis safe harbor election is made for Year 1.*

## Improvements

A taxpayer, generally, must capitalize amounts paid to improve a unit of property. The unit of property is determined based on a functional interdependence standard. Special rules are provided for buildings, plant property, and other assets.

Each building and its structural components is a single unit of property. Each of the following structural components, including the components thereof, constitutes a building system that is separate from the building structure, and to which the rules are applied:

- ◆ Heating, ventilation, and air conditioning (HVAC) systems
- ◆ Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets)
- ◆ Electrical systems (including wiring, outlets, junction boxes, lighting fixtures)
- ◆ All escalators
- ◆ All elevators
- ◆ Fire-protection and alarm systems
- ◆ Security systems for the protection of the building and its occupants
- ◆ Gas distribution system

Property is improved if the amounts paid for activities performed:

- ◆ are for a betterment to the property,
- ◆ restore the property, or
- ◆ adapt the unit of property to a new or different use.

### **Example**

*TW Corporation owns a building in which it conducts a retail business. The building has men's and women's restrooms on two of the three floors. The company decides to update the restrooms by paying to replace the plumbing fixtures in all of the restrooms, including all the toilets and sinks, with modern style plumbing fixtures of similar quality and function. The company must treat the amount paid to replace all of the toilets and all of the sinks as a restoration of the building and must capitalize the amount paid as an improvement to the building.*

*However, assume the same facts as above except that TW does not update all the bathroom fixtures. Instead, the company only pays an amount to replace 8 of the total of 20 sinks located in the various restrooms. The 8 replaced sinks, by themselves, do not comprise a significant portion of a major component (the 20 sinks) of the plumbing system and TW is not required to treat the amount paid to replace the eight sinks as a restoration of a building. TW can deduct the costs of the 8 sinks.*

## Repairs and Maintenance

Technically, a taxpayer may only deduct amounts paid for repairs and maintenance if the amounts paid are not otherwise required to be capitalized. However, from a practical standpoint, there are safe harbors that allow routine maintenance costs to be deducted. There is also a special safe harbor for small taxpayers.

Routine maintenance for a building consists of the recurring activities that a taxpayer expects to perform to keep the building structure or building system in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the building structure or system. However,

the activities are routine only if the taxpayer reasonably expects to perform the activities more than once during a 10-year period.

Routine maintenance for property other than buildings consists of the recurring activities that a taxpayer expects to perform to keep the property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the replacement of damaged or worn parts of the property with comparable and commercially available replacement parts. However, the activities are considered routine only if, the taxpayer reasonably expects to perform the activities more than once during the class life of the property.

The rules do permit a qualifying small taxpayer to elect to deduct rather than capitalize amounts paid if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of \$10,000 or two percent of the unadjusted basis of the building.

#### **Example**

*TW purchases a used machine with a class life of 10 years for use in its manufacturing operations. TW expects to perform manufacturer recommended scheduled maintenance on the machine approximately every three years. The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available replacement parts. At the time TW purchased the machine, the machine was approaching the end of a three- year scheduled maintenance period. As a result, in 2014, TW pays amounts to perform the manufacturer recommended scheduled maintenance. The majority of TW's costs do not qualify under the routine maintenance safe harbor because the costs were incurred primarily as a result of the prior owner's use of the property and not TW's use. Accordingly, the amounts paid must be capitalized if those amounts result in a betterment, including the amelioration of a material condition or defect, or otherwise result in an improvement under the new rules.*

*However, assume the same facts as above, except that after TW pays amounts for the maintenance in 2014, TW continues to operate the machine in its manufacturing business. In 2017, TW pays amounts to perform the next scheduled manufacturer recommended maintenance on the machine. TW's scheduled maintenance costs in 2017 are within the routine maintenance safe harbor and are deductible.*

## **Dispositions**

The new partial disposition election allows taxpayers to claim a loss upon the disposition of a structural component (or a portion thereof) of a building or any other asset. For example, a loss on the disposition of all or a portion of a roof. This applies even if a particular component was not previously broken out and identified as a separate asset on the fixed asset records. This is only available retroactively for the 2014 tax return filing; after which it is an annual election.

Therefore, even if a cost segregation study was not done previously, there is still an opportunity to do the analysis now to determine the basis for loss. The rules allow taxpayers to apply reasonable methods to determine the basis of the disposed asset in a multiple asset account. It is acceptable to use information readily available or known to the taxpayer including discounting the cost of the replacement asset using the applicable Producer Price Index.

### **Example**

*TW Corporation owns an office building with four elevators. The company replaces one of the elevators. The elevator is a structural component of the office building. TW does not make the partial disposition election. Thus, the retirement of the replaced elevator is not a disposition. As a result, depreciation continues for the cost of the building, including the cost of the retired elevator and the building's other structural components, and the company does not recognize a loss for this retired elevator.*

*However, assume TW makes the partial disposition election for the elevator. Although the office building, including its structural components, is the asset for disposition purposes, the result of the company making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. Thus, depreciation for the retired elevator ceases at the time of its retirement and TW recognizes a loss upon this retirement. Further, it capitalizes the amount paid for the replacement elevator and the replacement elevator is a separate asset for depreciation purposes.*

## **Accounting Method Changes and Elections**

The government has issued procedures under which taxpayers obtain automatic consent to file accounting method changes on Form 3115 to recoup additional deductions and losses and to comply with the new rules on 2014 tax returns. The rules also provide for the use of prospective elections, such as the annual *de minimis* election, to claim additional deductions on 2014 and future tax returns.

## **Conclusion**

The new rules are lengthy and complex but don't let that get in the way of taking action. We have broken down the process into steps to make it easier for you to think about and act on.

- 1 Understand your present methods and how you're accounting for them now
- 2 Compare the differences between your present situation and the new rules
- 3 Understand your units of property, building systems, and components
- 4 Quantify benefits and costs
- 5 Consider making elections
  - a *De minimis* safe harbor election
  - b Partial disposition election retroactively
  - c Small taxpayer safe harbor election
  - d Other elections
- 6 Determine if accounting method changes are needed in various areas
  - a Materials and supplies
  - b Improvements
  - c Repairs and maintenance
  - d Dispositions
  - e Acquisition and production costs
  - f Other method changes
- 7 Perform analysis and computations including cost segregation if needed
- 8 Revise accounting policies and procedures if necessary
- 9 Make elections on 2014 tax return
- 10 Compute 481(a) adjustments
- 11 File Form 3115 with 2014 tax return
- 12 Continue on new methods and make annual elections



If you'd like to ensure proper compliance and maximize the benefits the new regulations might afford you, engage an advisor with expertise on the new regulations. L. Harris Partners has that expertise and can help guide you through the new rules and the steps in the process to implement them.



For more information:

Mike Metz  
L. Harris Partners  
6900 Shady Oak Road, Suite 210  
Eden Prairie, MN 55344

Kevin Johnson  
L. Harris Partners  
6900 Shady Oak Road, Suite 210  
Eden Prairie, MN 55344

Email: [mike.metz@lharrispartners.com](mailto:mike.metz@lharrispartners.com)

Email: [kevin.johnson@lharrispartners.com](mailto:kevin.johnson@lharrispartners.com)

Website: [www.LHarrisPartners.com](http://www.LHarrisPartners.com)

Website: [www.LHarrisPartners.com](http://www.LHarrisPartners.com)

Phone: 952.944.3303

Phone: 952.944.3303