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REPAIR REGS



Taxation: “Repairs” or “Capitalization” of Expenditures Under the New Tangible Property Regulations

The recent tangible property regulations are the most dramatic changes in tax law to effect all types of business as well as individual since the overhaul of the Internal Revenue Code in 1986. These regulations have established new criteria for taxpayers to employ to determine whether an expenditure related to an asset is an improvement. Past criteria that was used to determine if an expenditure should have been capitalized, such as “we spent a lot of money”, or “the life of the asset was extended” are no longer considerations or determinants. Taxpayers must now only employ the new capitalization criteria (restoration, adaption, betterment, or improvement “the R.A.B.I. rules”) or risk losing deductions that were incorrectly capitalized.

Additionally, these new rules will require most taxpayers to:

- Determine and file annual new elections, such as the new de minimis safe harbor election that will allow a taxpayer to write off items of a certain dollar amount and under, such as all qualified items $1,000 and under;
- Defer, i.e. not write off currently, some material and supply purchases;
- Modify internal processes to comply with these new rules (such as a capitalization policy);
- Modify current and future documents (such as landlord/tenant leases);
- Change business practices (from landlord/tenant leasehold improvements negotiations to separating out removal costs on future invoices for improvement expenditures);
- Analyze the tax depreciation schedule to match the items on that schedule with the new criteria to determine if past capitalized items must now be written off, and/or to verify the proper asset class lives; and
- File one or more additional IRS forms and supporting schedules (i.e. applications for accounting method changes - IRS Form 3115) with the 2014 tax return.

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Complying with the laws will be demanding. Prior year fixed asset records or transactions are now needed to be revisited in light of the new rules. Not only will taxpayers be required to file one or more Form(s) 3115 for each accounting method change, it will need to be done for each separate entity, or trade or business. For example, an individual filing Form 1040 with three rental entities owned by LLCs will be required to file three (or more) separate sets of IRS Form(s) 3115 with supporting information.

Note that these regulations also can provide large potential current and future tax deductions. Generally, taxpayers will be able to expense greater amounts for expenditures then they thought possible. Those include repair and maintenance and the new "de minimis" amounts under a capitalization policy. In addition, taxpayers may be able to write off the net remaining tax basis of certain previously capitalized assets. For example, roof expenditures that were previously capitalized may now have their remaining depreciation currently written off if a roof improvement is (or was) subsequently made and/or if those expenditures did not arise to the level of being a R.A.B.I.

Caution and work are needed: Under these new regulations, if a taxpayer does not implement these new rules and properly file the necessary Form(s) 3115 under the correct new method(s) they may ***LOSE*** or ***DELAY*** their current or future tax depreciation or potential current write-off of previously capitalized assets. This is a serious issue for the 2014 tax year.

Most of the internal processes that will have to be changed deal with the following "must dos":

- Accounting for "non-incidental" material and supplies; now these should be deferred at tax year end and not expensed until put in place or used;
- Employment of a capitalization "write-off" policy dictating a certain write off amount (e.g., "our policy is that we are going to expense all purchases under $500"). If you do not, you may be limited to much lesser amounts;
- File the required 3115 forms and elections in future tax returns, and
- Review of the tax depreciation schedules to see what assets on that list qualify for write off in, ***and no later than***, tax year 2014.

While these regulations provided taxpayers with the option of adopting these changes in either the 2012 or 2013 tax year, the IRS had not finalized, and in fact, did change many of these rules. For example, if a taxpayer employed the change in 2012, subsequent forms may have to be filed to either modify or correct that filing. Accordingly, we recommend that taxpayers adopt and employ the new rules for the 2016 tax year. There are some exceptions to this for certain "small" taxpayers who can adopt and employ there changes in subsequent years.

These new IRS rules, criteria, and regulations are not going to be easy to implement. They are complicated and in many cases not clear. The facts and circumstances of each situation will need to be analyzed to determine the proper treatment of past, current and future expenditures.

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