



# Tax Update & Changes You Should Know

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# Overview

# Tangible Property Regulations - Background

- IRS released temporary regulations on 12/23/11
- In late 2011 IRS delayed effective date to years beginning on or after 1/1/14
- On 9/13/13 IRS issued final regulations to take effect for years beginning on or after 1/1/14
- Final regulations provide very favorable transition rules for specified annual elections



# Areas

- Materials and Supplies
- Capital expenditures in general (including the de minimus safe harbor)
- Costs to acquire or produce tangible property
- Costs to improve tangible property
- Dispositions of MACRS property (including components thereof) and general asset accounts (GAAs)



# **One – Materials and Supplies**

# One – Materials and Supplies

- Final regulations expand the definition to include items costing \$200 or less (increased from \$100) as well as emergency spare parts
- Must meet one of the following criteria
  - A component acquired to maintain, repair, or improve a unit of tangible property owned
  - Consists of fuel, lubricants, water, and similar items expected to be consumed in 12 months or less
  - Has an economic useful life of 12 months or less, beginning when first used or consumed
  - Has an acquisition cost of \$200 or less
  - Is identified in published guidance as materials and supplies



# One – Materials and Supplies

- Final regulations allow taxpayer to make an annual election to capitalize and depreciate rotables or standby emergency spare parts (temporary regulations allowed the election to capitalize any material and supply)
- Final regulations state that taxpayer may only revoke its election to capitalize and depreciate eligible materials and supplies via a letter ruling request



# Two – Capital Expenditures

## Two – De Minimis Safe Harbor

UOP may be expensed, up to \$5,000 per invoice or per item, if taxpayer:

Has applicable financial statement (AFS)

Has written AFS capitalization policy in effect at beginning of year

Expenses de minimis amounts on AFS pursuant to capitalization policy



## Two – Applicable Financial Statement (AFS)

- A financial statement required to be filed with the SEC
- A certified audited financial statement that is accompanied by the report of an independent CPA and used for credit purposes, reporting to owners, or any other substantial non-tax purpose
- A financial statement required to be provided to the federal or state government or any federal or state agencies (other than the SEC or IRS)



## Two – De Minimis Rule – no AFS

- Taxpayer without AFS can expense amounts up to \$500 per invoice or item if both of the following apply
  - At the beginning of the tax year, accounting procedures for expensing amounts paid for property either costing less than a certain dollar amount or with an economic useful life of 12 months or less
  - Treats such amounts as expenses on its books and records in accordance with such procedures



## Two – Part 32 Considerations

- FCC Part 32 system of accounts have the following guidelines for capitalization
  - 2112 Motor Vehicles, 2113 Aircraft, 2114 Tools and other work equipment, 2122 Furniture, 2123 Office equipment, 2124 General purpose computers costing \$2,000 or less shall be charged to the applicable expense accounts
  - Personal computers in the 2124 account costing \$500 or less shall be charged to the applicable expense accounts
  - Central office tools and test equipment in accounts 2210-2232 costing \$2,000 or less shall be charged to the expense accounts



# Three – Costs to Acquire or Produce Tangible Property

# Three -Costs to Acquire or Produce Tangible Property

Final regulations, much like the temporary regulations, generally require the capitalization of amounts paid or incurred to acquire or facilitate the acquisition of real and personal property.

- Both sets of regulations allow taxpayers to treat costs as nonfacilitative if they relate to the determination of whether to acquire real property and which real property to acquire
- Note that this only applies to real property and not personal property



# Three -Costs to Acquire or Produce Tangible Property

- Contingency fees are deemed facilitative and must be included in the basis of property acquired
- Other inherently facilitative amounts may be allocated between the basis of property acquired and property not acquired
- Employee compensation and overhead are excluded from the definition of facilitative amounts
  - However, taxpayers may elect to treat such amounts as capitalizable
  - If election is made, it is generally can not be revoked



# Four – Costs to Improve Tangible Property

# Four -Costs to Improve Tangible Property

Final regulations, much like the temporary regulations, generally require the capitalization of amounts paid or incurred for the improvement of property.

- To determine if unit of property (UOP) is improved, see if amounts expended lead to one or more of the following:
  - Betterment of UOP
  - Restoration of UOP
  - Adaptation of UOP to a new and different use



## Four – Betterment of UOP

- An amount results in betterment of a UOP does one of the following:
  - Corrects a material condition or defect that existed prior to the taxpayer's acquisition of the UOP or arose during production of the UOP
  - Is for a material addition to the UOP or a material increase in capacity of the UOP
  - Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the UOP



## Four – Betterment of UOP

- Final regulations clarify that a material addition includes the addition of a “major component”
- Final regulations also modify the temporary regulation language in stating that the material increase in the productivity, efficiency, strength, quality, or output of the UOP by providing that the amount is deemed to result in betterment in this case only if it is “reasonably expected” to result in a material increase in one of these factors
- Taxpayer is encouraged to apply both qualitative and quantitative factors to analysis



## Four – Betterment of UOP

- Final regulations clarify that “comparison rule” is only applicable in certain situations
  - When amounts are expended to correct wear and tear
  - Damage to a UOP that occurred during the taxpayer’s use of property



# Four – Restoration of UOP

- An amount results in a restoration if the amount
  - Is for the replacement of a component of a UOP for which the taxpayer has properly deducted a loss other than a casualty loss
  - Is for the replacement of a component of a UOP for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss from the sale or exchange of each component
  - Is for the restoration of damage to a UOP for which the taxpayer is required to take a basis adjustment as a result of a casualty loss
  - Returns the UOP to its ordinarily efficient operating condition if the property has deteriorated into a state of nonfunctional disrepair
  - Results in the rebuilding of a UOP to a like-new condition after the end of its class life
  - Is the replacement of a major component or substantial structural part of a UOP



# Four – Restoration of UOP

- Regulations add salvage exception for taxpayers that pay or incur costs for the replacement of a component unit of pre-MACRS property where the taxpayer has one of the following:
  - Has properly deducted a loss other than a casualty loss
  - Has recognized a loss as the result of a sale or exchange of the component



# Four – Restoration of UOP

- Final Regulations clarify the definitions of “major component” and “substantial structural part”
  - Major component is defined as a part or combination of parts that performs a discrete and critical function in the operation of the UOP
  - Substantial structural part is defined as a part or combination of parts that comprises a large portion of the physical structure of the UOP
- Final Regulations clarify that an amount will be treated as paid for the replacement of a major component if it is paid for the replacement of a major component or a significant portion of the major component.



# Four – Adaptation of UOP

- An amount results in an adaptation to a UOP if it is paid to adapt a UOP to a new or different use that is consistent with the taxpayer's ordinary use of the property at the time originally placed into service by the taxpayer.
- Final regulations added three examples to illustrate the application of the adaptation standard
  - Reconfiguration of a retail drug store to add a walk-in medical clinic (adaptation)
  - Addition of a sushi bar to a grocery store that already contained a prepared food section with made-to-order options (not an adaptation)
  - Modification of a hospital emergency room to allow for both emergency care and outpatient surgery (not an adaptation)



# **Five – Treatment of Dispositions of Property and General Asset Account Treatment**

# Five – Establishing General Asset Accounts

- Taxpayers may elect general asset account (GAA) treatment for one or more items of MACRS property
- If GAA includes multiple assets, each asset must:
  - Have same depreciation method
  - Have same recovery period
  - Have same convention
  - Placed in service in the same tax year



# Five – Establishing General Asset Accounts

- Assets are included in GAAs only to the extent of the asset's unadjusted depreciable basis
- Taxpayer must calculate depreciation allowances for each GAA as though each GAA is one asset by aggregating the unadjusted depreciable basis of each asset included in the GAA and calculating the depreciation allowance on the total unadjusted depreciable basis of the GAA
- Election to apply the GAA generally can not be revoked



# Five – Dispositions of General Asset Accounts

- Dispositions of assets in GAA will generally not be recognized for federal income tax purposes
- Proposed regulations provide that building (including structural components) is treated as the asset, which is a change from the temporary regulations, which made the structural components a separate asset



## Five – Qualifying Disposition Election for GAA

- Proposed regulations allow for an election to recognize a qualifying disposition when a disposition does not involve all the assets, or the last asset, remaining in a GAA, and that is one of the following:
  - A direct result of a fire, storm, shipwreck, or other casualty, or from theft
  - A deductible charitable contribution
  - A direct result of a cessation, termination, or disposition of a business or process
  - A transaction to which a non-recognition section of the code applies



## Five – GAA - Example

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

Single asset account	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	Capitalize and depreciate cost of new roof	Capitalize and depreciate cost of new roof



# Five –Election to recognize disposition of all or the last asset in a GAA

- Proposed regulations allow for an election to recognize a disposition of all the assets or the last asset in a GAA
- If the election is made, the taxpayer terminates the GAA in the year of disposition and determines gain or loss by taking into account the adjusted depreciable basis of the GAA at the time of the disposition



## Five –Disposition of MACRS property (not in GAA)

- Proposed regulations state that disposition occurs upon the disposal of a portion of an asset (such as a structural component of a building) only where the taxpayer makes the partial disposition election
- Partial disposition election is available



# **Six – Summary of Changes in Final and Proposed Regulations**

# Six – Summary of Significant Changes in Final and Proposed Regulations

Issue	Temporary Regulations	Final Regulations
Definition of materials and supplies (M&S)	Amount paid for a UOP costing \$100 or less	Amount paid for a UOP costing \$200 or less
M&S interaction with de minimus rule	Taxpayer can elect to include M&S under the de minimus rule	If taxpayer elects de minimus safe harbor, supplies that fit must be accounted for under that rule
De Minimus rule	Only available for taxpayers with an AFS	Taxpayers without and AFS eligible, but amount paid for the property is limited to \$500





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