IRS Issues Tangible Assets Regulations

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The Internal Revenue Service (IRS) issued on Dec. 23, 2011, the much-anticipated regulations that govern the capitalization of amounts paid to acquire, produce, or improve tangible property. The regulations were issued in temporary form and generally are effective for tax years beginning on or after Jan. 1, 2012. They update and expand the proposed regulations issued in March 2008. These regulations are separate and distinct from the Uniform Capitalization Rules under section 263A of the Internal Revenue Code which are more closely associated with amounts capitalized to inventory.

A large focus of the regulations is to provide guidance for determining whether expenditures are repairs, (which could be currently expensed) or capitalized improvements (which must be depreciated) for tax purposes. The regulations are very comprehensive, cover the different aspects of capitalization of costs related to acquiring, improving, and disposing of tangible property, and will affect the vast majority of automotive dealerships.

Many provisions in these regulations will require a change of accounting method and a cumulative taxable income adjustment; however, some of the provisions only affect costs paid or incurred in tax years beginning on or after Jan. 1, 2012. The IRS has stated that additional guidance on implementing the regulations will be forthcoming.

For dealerships, the regulations are most relevant in determining the proper treatment of costs incurred for image upgrades required by the auto manufacturers, including showroom, customer waiting area, and exterior façade updates. Another significant opportunity for dealers may be large repair expenditures such as major roof repairs.

What constitutes an improvement to tangible property?

A taxpayer generally must capitalize expenditures paid to improve a unit of property owned by the taxpayer. A unit of property is improved if the amounts paid:

- Result in a betterment of the property;
- Restore the unit of property; or
- Adapt the unit of property to a new or different use.

What constitutes a betterment to tangible property?

An amount paid results in a betterment only if the expenditure:

- Corrects a material condition or defect that either existed prior to the taxpayer's acquisition of the property or arose during the production of the property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;
- Results in a material addition (including a physical enlargement, expansion, or extension) to the property; or
- Results in a material increase in capacity (including additional cubic or square foot space), productivity, efficiency, strength, or quality of the property or the output of the property.

What are some of the things that should be considered in determining if there has been a betterment to property?

The determination of whether a betterment has occurred is based on the facts and circumstances of the situation. Factors to consider include:

- Purpose of the expenditure
- Physical nature of the work performed
- Effect of the expenditure on the property
- Taxpayer's treatment of the expenditure on its applicable financial statement

To determine if a betterment has occurred a comparison is made between the condition of the property immediately after the expenditure and the condition of the property immediately before the circumstance

triggering the need for the expenditure. If the situation involves normal wear and tear, the comparison is made to the property immediately after either the last time the maintenance for wear and tear was performed or, if such maintenance has not previously taken place, with the condition of the property when placed in service by the taxpayer.

Does consideration need to be given to the type of replacement part or components in determining if a betterment has occurred?
The regulations also stipulate that if a taxpayer is unable to obtain a comparable replacement part (due to technological advancements or product improvements, for example), the mere fact that the part is replaced with an improved part will not, by itself, cause the expenditure to be treated as a betterment of the property.

What constitutes a restoration to tangible property?
For purposes of these rules, an amount is paid to restore property only if it:

- Is for the replacement of a component of the property and the taxpayer has properly deducted a loss for that component (other than a casualty loss);
- Is for the replacement of a component of the property and 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;
- Is for the repair of damage to a property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss or relating to a casualty event;
- Returns the property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;
- Results in the rebuilding of the property to a like-new condition after the end of its class life; or
- Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a property.

Do the temporary regulations allow for any safe harbor methods?
A safe harbor is provided for routine maintenance on property other than buildings. The safe harbor allows taxpayers to treat routine maintenance costs as currently deductible and not an improvement to tangible property. To be considered routine maintenance, the taxpayer has to expect to perform these services more than once during the class life of the property. Routine maintenance includes inspecting, cleaning, and testing a property and replacing parts of the property with comparable and commercially available and reasonable replacement parts.

How do the regulations address a minimum capitalization policy?
The temporary regulations establish a threshold that allows taxpayers who meet certain criteria the option of not capitalizing costs for items under a specified amount that have a useful life greater than 12 months. A special *de minimis* rule can be applied by a taxpayer who meets all of the following criteria:

- Has an applicable financial statement that is either:
    - Filed with the Securities and Exchange Commission (SEC);
    - A statement audited by an independent certified public accountant that is used for credit purposes, reporting to equity holders, or for any substantial nontax purpose; or
    - A statement other than a tax return required to be provided to an agency of the federal or a state government (other than the IRS or the SEC);
- The taxpayer had written accounting procedures in place at the beginning of the taxable year treating amounts below a certain figure as an expense for nontax purposes;
- The amounts are treated as an expense on the applicable financial statement; and
- The total amount of such expensed items are less than or equal to the greater of:
    - 0.1 percent of federal income tax reported gross receipts for the year, or
    - 2 percent of the taxpayer’s depreciation and amortization expense reported on the applicable financial statement.

Costs that a taxpayer classifies as de minimis in excess of the established caps will be required to be capitalized.

Does the de minimis rule apply to all taxpayers?
Not all taxpayers have an "applicable financial statement" under these rules and thus will not qualify for the *de minimis* method. The rule generally will apply to those taxpayers that have an audited financial statement prepared under U.S. generally accepted accounting principles.

Does the de minimis rule apply to all costs?
The *de minimis* method cannot be used for inventory or for land costs. A taxpayer can elect not to apply the *de minimis* rule to any property acquired during the year simply by capitalizing the amounts in question on its timely filed federal income tax return.

Recommendations

The new temporary regulations likely will affect the vast majority of taxpayers who own or lease tangible personal or real property. Taxpayers should review the temporary regulations and related examples to assess the impact they might have on the treatment of costs considered to be capitalized versus expensed. In addition, taxpayers should review what changes, if any, will need to be made to costs currently capitalized or their own capitalization procedures to comply with the new regulations. Changes made to comply with these new regulations will require the filing Form 3115, "Application for Change in Accounting Method." It is anticipated that these method changes will be filed under the automatic consent procedures. You should work with your tax professional to determine how the new rules apply to your facts and circumstances and to assess the requirement to file an accounting method change.

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