Final IRC §263(a) Tangible Property Regulations Technical Update

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With You Today

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“The temporary regulations will affect all taxpayers that acquire, produce, or improve tangible property.”

Estimated Number of Respondents: 4,000,000 taxpayers
Estimated Total Annual Reporting Burden: 1,100,000 hours

• Introduction
• De Minimis Expensing Rule
• Materials and Supplies
• Acquisition or Production of New Property
• Unit of Property
• Capitalization Standards
• Dispositions
• Other Considerations
• Election and Method Changes
• Significant Differences in Final and Proposed Regulations
Introduction

Legislative History

On September 13, 2013, the IRS and Treasury Department released final regulations that affect the treatment of materials and supplies, capitalization of amounts paid to acquire or produce tangible property, and the capitalization and deduction of expenditures relating to repair or improvement of tangible property. The IRS also released proposed disposition regulations. These regulations will have implications on most taxpayers regardless of industry.

Below is the recent history of these regulations

- Proposed regulations issued August 18, 2006
- Re-proposed regulations issued March 7, 2008
- Temporary and proposed regulations issued December 23, 2011
- Final and new proposed regulations issued September 13, 2013
Introduction

Transition Rules

• Revenue Procedures with accounting method transition guidance expected to be released before year end, possibly in October
• Anticipate simplified procedures for change of accounting methods
• Mandatory application of final regulations in 2014
• Transition years 2012 and 2013:
  – Option to adopt to apply final regulations retroactively to 2012 and/or 2013
  – Apply temporary regulations to 2012 and/or 2013
  – Apply existing law to 2012 and 2013
Final Tangible Property Regulations

Significant Changes

The following are significant changes between the temporary and final regulations:

• De Minimis Rule: $5,000 per item book-conformity safe harbor
• Materials and Supplies: Definition increased amount to $200
• Routine maintenance safe harbor: Extended application to real property (with ten year testing period)
• Small business relief for yearly improvements: $10,000 test
• Annual election to follow book capitalization policy
• Disposition rules significantly modified
Tangible Property Regulations: Determining Deductibility Overview

- Is an expenditure deductible?
  - No

- Does De Minimis Safe Harbor apply?
  - Yes
  - Deductible Expenditure
  - No

- Does Routine Maintenance apply? Cannot include to Improvements.
  - Yes
  - Deductible Expenditure
  - No

- Does Small Taxpayer Safe Harbor apply?
  - Yes
  - Deductible Expenditure
  - No

- Is this improvement to property?
  - Yes
  - Capitalize Expenditure
  - No
De Minimis Expensing Rule: §1.263(a)-1(f)
De Minimis Expensing Rule

Safe Harbor

- Ceiling in 2011 temporary regulations replaced with a safe harbor.
- Required to have a written policy at the beginning of the taxable year expensing amounts paid for:
  - Property costing less than a specified dollar amount, or
  - Property with a useful life of 12 months or less
- Expense in applicable financial statement (AFS) in accordance with the written policy
- Amount paid for the property does not exceed $5,000 per invoice (or per item, if substantiated on the invoice)
- If no AFS, then replace the $5,000 amount with $500 per invoice/item
Applicable Financial Statements

Taxpayer’s applicable financial statements are defined as:

- Financial Statement required to be filed with the SEC
- Certified audited financial statement accompanied by the report of an independent CPA (or foreign equivalent)
- Certified audited financial statement (other than a tax return) required to be provided to the federal or state government or any federal or state agency
- Reviewed financial statements do not qualify as applicable financial statements
De Minimis Expensing Rule
Safe Harbor Considerations

- Election requires the inclusion of materials and supplies except for:
  - Rotable, temporary and standby emergency spare parts that a taxpayer elects to capitalize and depreciate
  - Rotable and temporary spare parts for which the optional method has been elected

- Transaction and additional costs (e.g., delivery fees, installation costs) are included if identified on the same invoice as the property

- Does not apply to inventory or land

- 263A applies to amounts expensed under the de minimis rule

- Requires an annual, irrevocable tax return election

- May be applied at the “group” level

- May amend for 2012 and 2013 if written policy was in place

- Not intended to prevent a taxpayer from reaching an agreement with the IRS if clear reflection of income
De Minimis Expensing Rule

Safe Harbor Election

• Statement must be attached *annually* to a timely filed (including extensions) income tax return

• Statement must be titled “Section 1.263(a)-1(f) de minimis safe harbor election” and contain the following information:
  – Taxpayer’s name
  – Address
  – Taxpayer identification number
  – Statement that the taxpayer is making the de minimis safe harbor election under Section 1.263(a)-1(f)

• Parent must list the names and tax identification numbers of each group member making the election
De Minimis Expensing Rule
Industry Concerns

- Expensing costs as de minimis that should be capitalized and depreciated
- De minimis policy not in writing
- De minimis policy not followed for AFS purposes
- De minimis policy set in excess of $500 or $5,000 maximum
- Deduct bulk purchases according to item amount, not invoice amount
- Sec. 263A must still be applied
Materials and Supplies: §1.162-3
Materials and Supplies

Definition

Tangible property that is used or consumed in the taxpayer’s operations that is not inventory and:

- Is a component acquired to maintain, repair, or improve a unit of property owned, leased or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property
- Consists of fuel, lubricants, water and similar items that are reasonably expected to be consumed in 12 months or less
- Is a unit of property that has an economic useful life of 12 months or less, beginning when the property is used or consumed
- Is a unit of property that has an acquisition or production cost of $200 or less
- Is identified in published guidance as a material and supply
Materials and Supplies
Treatment

• General rule remains the same:
  – Incidental materials and supplies are deductible in the year purchased
  – Non-incidental materials and supplies are deductible when used or consumed

• New provisions:
  – New definition for “standby emergency spare parts”
  – Election to capitalize and depreciate materials and supplies is permitted only for rotable, temporary, or standby emergency spare parts
  – Optional Method election permitted for rotable and temporary spare parts
  – Deduct any material and supply in the year purchased if de minimis safe harbor election is made (excluding amounts under the above two elections)
Materials and Supplies

Industry Concerns

• If de minimis election is made, treat all M&S as de minimis expenses

• Appropriate treatment where M&S are not deducted where the de minimis safe harbor is elected
Acquisition or Production of Property: §1.263(a)-2
Acquisition or Production of Property
§1.263(a)-2

A taxpayer must capitalize costs incurred to acquire or produce a unit of real or personal property.

- Were costs of employee compensation or overhead incurred to acquire property? 
  - YES: Optional capitalization permitted by election, not required
  - NO
    - Were inherently facilitative amounts incurred to determine whether to acquire real property? 
      - YES
        - Optional capitalization permitted by election, not required
      - NO
        - Were costs incurred prior to the property being placed in service, such as repair or installation costs? 
          - YES
            - Was this an acquisition cost of property? 
              - YES
                - Capitalize
              - NO
                - Were amounts paid to defend or protect title to real or personal property? 
                  - YES
                    - Were transaction costs incurred to facilitate acquisition or production of property? 
                      - YES
                        - Capitalize
                      - NO
                        - Do not capitalize
                    - NO
                      - Do not capitalize
                - NO
                  - Capitalize
          - NO
            - Do not capitalize
Acquisition or Production of Property
Inherently Facilitative Amounts

Examples of inherently facilitative amounts include:

- Transporting the property
- Securing an appraisal
- Negotiating the terms or structure of acquisition and tax advice
- Application fees, bidding costs
- Preparing and reviewing documents that effectuate the acquisition
- Examining and evaluating the title
- Obtaining regulatory approval and permits
- Conveying property between parties
- Finders’ fees or brokers’ commissions
- Architectural, geological, survey, engineering, environmental, or inspection services
- Services of a qualified intermediary or other facilitator of a Sec. 1031 exchange
Acquisition or Production of Property

Amounts paid in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire. Such costs are not capitalized.

Elect to treat amounts paid for employee compensation and/or overhead as amounts that facilitate the acquisition of real or personal property. Such cost would then be capitalized separately for each acquisition. Election is made by the taxpayers treatment on the timely filed original tax return (including extensions) for the taxable year amount is paid.
Acquisition or Production of Property  
Defense of Title

Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property and require capitalization.

- Taxpayer incurs legal fees to contest a condemnation complaint under eminent domain. Amounts paid must be capitalized as a cost to defend title to the property.

- Taxpayer incurs legal fees after municipality passes an ordinance that prohibits the operation of it’s established business. Amounts paid to preserve business activities is not required to be capitalized.

- Taxpayer incurs legal fees after a public works establishes a building line across business property, adversely affecting the value of the property. Amounts paid must be capitalized as cost to defend title to the property.
Acquisition or Production of Property
Industry Concerns

- Costs incurred to determine whether to acquire real property or which property to acquire are deductible

- Capitalize costs to defend title to property

- Internal labor and overhead are not facilitative costs and are not required to be capitalized

- Facilitative costs must be capitalized

- Must still apply 263A capitalization to acquired or produced property
Unit of Property: §1.263(a)-3(e)
Improvements to Property Application

- Unit of Property
- Improvements to Property
- Safe Harbor for Routine Maintenance
- Disposition
Unit of Property
Buildings
Unit of Property
Leased, Co-op or Condo Property

Was the expenditure for the repair or improvement of:

- UOP is the portion of each building and building systems subject to the lease
- Is the taxpayer’s ownership interest the entire building?
  - YES: UOP is the entire building system or building structure
  - NO: UOP is the portion of the building and/or building system in which the taxpayer has possessory rights

Lessee

Condo

UOP is the individual unit owned and its structural components
# Unit of Property

Common Examples of Building System Components

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<tr>
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<tbody>
<tr>
<td>• Roof</td>
<td>• Motors</td>
<td>• Pipes</td>
<td>• Wiring</td>
<td>• Rails</td>
<td>• Sensing &amp; Detection Devices</td>
<td>• Pipes</td>
<td>• Pipes</td>
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<tr>
<td>• Walls</td>
<td>• Compress. Boilers</td>
<td>• Drains</td>
<td>• Outlets</td>
<td>• Steps</td>
<td>• Computer Controls</td>
<td>• Gas Utility Equipment</td>
<td>• Gas Utility Equipment</td>
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<td>• Floors</td>
<td>• Furnace</td>
<td>• Valves</td>
<td>• Junctions</td>
<td>• Supporting Equipment</td>
<td>• Sprinkler Heads &amp; Mains</td>
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<td>• Ceilings</td>
<td>• Chillers</td>
<td>• Sinks</td>
<td>• Lighting</td>
<td>• Controls</td>
<td>• Piping &amp; Plumbing</td>
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<td>• Foundation</td>
<td>• Pipes</td>
<td>• Bathtubs</td>
<td>• Fixtures &amp;</td>
<td>• Alarms</td>
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<td></td>
<td>• Ducts</td>
<td>• Toilets</td>
<td>Connectors</td>
<td>• Control</td>
<td>• Entry Access</td>
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<td>• Radiators</td>
<td>• Water and Sanitary</td>
<td>• Elec. Utility Equip.</td>
<td>• Panels</td>
<td>• Monitors</td>
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<td>Sewer Collection</td>
<td>Equip.</td>
<td>• Signage</td>
<td>• Motion Detectors</td>
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<td>Equip.</td>
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<td>• Recorder</td>
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<td>• Security Cameras</td>
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<td>• Security Lighting</td>
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<td>• Alarms</td>
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</table>

**Building Unit(s) of Property and Common Components**
Unit of Property
Property Other than Buildings

General Rule: Functional Interdependence

Plant Property: Discrete and Major Function

Network Assets
Unit of Property
Defined for Property Other than Buildings

Functionally Interdependent:
Comprises a single unit of property when the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

Plant Property:
Unit of Property as determined is 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.

Network Assets:
Railroad track
Oil and gas pipelines
Water and sewage pipelines
Power transmission
Distribution lines
Telephone and cable lines
Unit of Property is determined by the taxpayer’s particular facts and circumstances except as provided in published guidance.
## Unit of Property Examples

### Real Property

<table>
<thead>
<tr>
<th>Real Property</th>
<th>Expenditure</th>
<th>UOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Store - Stand-alone</td>
<td>Store Refresh - Lighting</td>
<td>Electrical system</td>
</tr>
<tr>
<td></td>
<td>replacement</td>
<td></td>
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<tr>
<td>Retail Store - Shopping Mall</td>
<td>Store Refresh - Lighting</td>
<td>Leased portion of building</td>
</tr>
<tr>
<td>(leased space)</td>
<td>replacement</td>
<td>electrical system</td>
</tr>
<tr>
<td>Office - Owned building</td>
<td>Remove conference room wall</td>
<td>Building structure</td>
</tr>
<tr>
<td>Office - Leased space</td>
<td>Remove conference room wall</td>
<td>Building structure within leased</td>
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<td></td>
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<td>space</td>
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<tr>
<td>Manufacturing Plant</td>
<td>Roof replacement</td>
<td>Building Structure</td>
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<tr>
<td>Apartment Building</td>
<td>Single Unit Heat/Air replacement</td>
<td>Building HVAC System</td>
</tr>
</tbody>
</table>
## Unit of Property Examples

### Personal Property

<table>
<thead>
<tr>
<th>Personal Property: Non-Building</th>
<th>Expenditure</th>
<th>UOP</th>
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</thead>
<tbody>
<tr>
<td>Restaurant oven</td>
<td>Burner replacement</td>
<td>Oven</td>
</tr>
<tr>
<td>Garbage truck</td>
<td>Engine repair / replacement</td>
<td>Truck</td>
</tr>
<tr>
<td>Apartment unit furnishings</td>
<td>New carpet for individual unit</td>
<td>Carpet</td>
</tr>
<tr>
<td>Donut bakery manufacturing line - Interconnected mixers, ovens, conveyers, loaf slicer, packaging</td>
<td>Knife replacement / sharpening</td>
<td>Slicer component</td>
</tr>
<tr>
<td>Retail Donut Store Bakery - Interconnected mixers, ovens, conveyers, loaf slicer, packaging</td>
<td>Knife replacement / sharpening</td>
<td>Entire baking line</td>
</tr>
</tbody>
</table>
Capitalization Standards:
§1.263(a)-3
Improvement Standards

Examples

• “Is this an improvement or a repair?” is generally not an easy question and one to which the answer is often “It depends.”

• There are no bright line tests. Capitalization is dependent on the facts and circumstances of each unique case. The series of examples that follow provide help in making a determination as to this requirement.

• The regulations contain numerous examples for further guidance. The following examples are numbered to correspond to each applicable section of the regulations.

• Special note should be taken of the following
  – Functionality - Degree of activities performed to improve a unit of property
  – Physical nature - Volume or square footage of improvement to a unit of property
Improvements to Property

Betterment

Adaptation

Restoration
Improvements Standards

Apply the following tests to the UOP to determine whether the expenditure is a capital expenditure:

**Betterment?**
- Correct pre-existing material condition or defect;
- Material addition or expansion; or
- Reasonably expected to materially increase the productivity, efficiency, strength, quality, or output.

![Branch 1](Diagram)

**Adaptation?**
- New or different use inconsistent with the intended use when originally placed in service by the taxpayer

![Branch 2](Diagram)

**Restoration?**
- Replace and recognize loss on replaced component;
- Recognize gain/loss and make a basis adjustment from sale of a component;
- Basis adjustment as a result of a casualty loss;
- Returns UOP to its ordinarily efficient operating condition if it has deteriorated to a state of disrepair and is no longer functional for its intended use
- Return UOP to “like-new” condition after the end of its class life; or
- Replace major component or substantial structural part of UOP

![Branch 3](Diagram)

**YES**
- YES
- Deduct as a repair expense

**NO**
- NO
- CAPITALIZE

![Diagram](Diagram)
Improvement Standards
Betterment

An amount is paid for a betterment to a UOP if it:

• Ameliorates a **material condition or defect** that either existed prior to the taxpayer’s acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;

• Is for a **material addition**, including a physical enlargement, expansion, extension, or addition of a major component to the UOP or a **material increase** in the capacity, including additional cubic or linear space, of the UOP; or

• Is reasonably expected to **materially increase** the productivity, efficiency, strength, quality, or output of the UOP.
Betterment Examples

A taxpayer replaces wooden shingles with comparable asphalt composite shingles. The new shingles are not an material increase in quality, capacity, productivity or efficiency, and therefore are NOT A BETTERMENT.

However, if the new shingles are replaced with new shingles that are maintenance free, have a longer warranty period, or with a significantly higher fire rating, then the new shingles are a BETTERMENT and require capitalization. {Example 3}

A retail chain refreshes its stores to maintain the appearance and functionality of its store buildings after several years of wear. The work consists of replacing and reconfiguring display tables and racks to provide better exposure of the merchandise, lighting relocations, flooring repairs, moving one wall to accommodate the reconfigured tables, patching holes in walls, repainting, replacing ceiling tiles, cleaning flooring, and power washing the building. The display tables and racks constitute 1245 property.

The refresh is NOT a BETTERMENT because it did not materially increase the productivity, efficiency, strength, quality, or output of the building structure or system. Taxpayer must capitalize the amounts paid for the 1245 property. {Example 6}

Same as above, except, in the course of the refresh to one of its store buildings, the taxpayer also pays amounts to increase the storage space, add a second loading dock, a second overhead door, and upgrades to the electrical system at the same time as the refresh.

Amounts paid to increase storage space, add loading dock, install overhead door, and for electrical upgrades are deemed BETTERMENTS and must be capitalized. However, for reasons discussed in the above example, taxpayer is not required to treat the amounts paid for the refresh as a betterment. {Example 7}
Improvement Standards

Adaptation

An amount is paid for an adaptation to a UOP if it:

• Adapts property to a new or different use.

• Adaptation is not consistent with taxpayer’s ordinary use of the UOP at the time originally placed in service by the taxpayer.
Adaptation Examples

A taxpayer owns a building consisting of retail spaces that were designed to be reconfigured. One tenant wishes to expand its occupancy to include two adjoining retail spaces. The taxpayer pays an amount to remove the walls between the three retail spaces. Assume the walls between spaces are part of the building and its structural components.

Amounts paid to convert the retail spaces into one larger space for a tenant DOES NOT ADAPT taxpayer’s building structure to a new or different use and is not required to be capitalized. {Example 2}

Taxpayer owns a grocery store. Taxpayer decides to add a sushi bar for its customers. Expenditures were made for counter and chairs, additional wiring and outlets, additional pipes and a sink, replacement of flooring and wallcoverings.

The amount paid to convert part of the retail grocery to a sushi bar is NOT an ADAPTATION. The sale of sushi is consistent with the taxpayer’s intended, ordinary use of the building structure and the systems in the grocery sales business, which includes selling food to its customers at various specialized counters. {Example 6}

Amounts paid by ManuCo to re-grade land for residential purposes adapts the land to a new or different use that is different than ManuCo’s original use.

Therefore, the costs to re-grade the land must be capitalized as an ADAPTATION of the property to a new or different use. {Example 4}
Restoration Examples

RESTORATION

Replacement of the entire roof (decking, insulation) {Example 14}
Replace chiller in office HVAC system (consists of one chiller, one boiler, pumps, duct work, diffusers, air handlers) {Example 16}
Replacement of sprinkler system in a building {Example 19}
Retail business replaces the plumbing fixtures in all of its restrooms (no piping) {Example 22}
Hotel replaces all bathtubs, sinks in hotel rooms in 4 of the 20 floors; intends to complete renovation of the remaining rooms over next 2 years {Example 23}
Replaces 200 of the 300 exterior windows (total windows are 25% of the building surface area) {Example 26}
Replaces 100 of 300 windows, but the windows cover 90% of the building surface {Example 27}
Replace all floors in the public areas of a hotel - public areas represent 40% sq ft {Example 29}

NOT A RESTORATION

Replacement of waterproof rubber membrane {Example 15}
Replacement of one furnace - HVAC system consists of 3 furnaces, duct work, etc. {Example 16}
Replacement of 3 of 10 rooftop units in HVAC system - HVAC system consists of 10 rooftop units, ductwork, etc. {Example 18}
Replace 30% of wiring to meet building code {Example 21}
Replace 8 of 20 sinks in restrooms in a retail store (no piping) {Example 23}
Replace 100 of 300 exterior windows (windows cover 25% of exterior surface) {Example 25}
Replace flooring in lobby - 10% of the sq. ft. of the entire hotel building {Example 29}
Book Capitalization Election

Election to Follow Book

Taxpayers may elect to capitalize repair and maintenance consistent with those capitalized on its books and records

- Annual election to treat repairs and maintenance as improvements,
- Election applies to ALL amounts paid for repairs and maintenance that are capitalized on the taxpayers books and records.
- Election is irrevocable
- Amounts expensed on books and records remain subject to the Code and regulations and must be analyzed for compliance
- May elect back to 2012 through amended returns
Small Taxpayers
Safe Harbor

New Safe Harbor provided for small taxpayers:

- Election to not capitalize repairs, maintenance, or improvements
- Applies to taxpayers with three-year average gross receipts not to exceed $10 million
- Applies to owned or leased buildings with unadjusted basis not to exceed $1 million
- Total amount paid during the tax year for repairs, maintenance, and improvements cannot exceed the lessor of:
  - 2% of the unadjusted basis of the building, or
  - $10,000
Small Taxpayers
Illustration

Small taxpayer with three-year average gross receipts of $8 million owns Building A with an unadjusted basis of $1.5 million and Building B with an unadjusted basis of $900,000

- Safe Harbor applies to taxpayer as average gross receipts are less than $10 million

- Safe Harbor does not apply to Building A as unadjusted basis is greater than $1 million

- Safe Harbor applies to Building B as unadjusted basis is less than $1 million
  - Taxpayer can elect to not capitalize repairs, maintenance, or improvements
  - Total amount paid during the tax year for repairs, maintenance, and improvements to Building B cannot exceed $10,000 which is the lesser of 2% of the unadjusted basis of the building ($18,000) or $10,000
Routine Maintenance Safe Harbor
Real and Personal Property

Amount paid is deemed NOT to improve the UOP 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 UOP in its ordinarily efficient operating condition

- Routine maintenance for non-building property: activity is expected to be performed more than once during the ADS class life

- Expanded to include routine maintenance for building property - substitute 10-year period for ADS class life

- Does not apply to:
  - Betterments
  - Restoration standards relating to loss on replaced component, casualty loss, and restoration from a state of disrepair
  - Network assets
  - Certain rotable spare parts
Routine Maintenance Safe Harbor

Taxpayers are permitted to deduct costs as routine maintenance under this safe harbor if the following tests are met:

- Were costs incurred for routine maintenance on a UOP?
  - YES
  - NO

- Were the activities performed as a result of the taxpayers use of the property?
  - YES
  - NO

- Were the costs to keep the UOP in ordinary operation condition?
  - YES
  - NO

- Did the activities include costs activities such as cleaning, inspecting, testing and replacement of components with comparable parts?
  - YES
  - NO

- Did the taxpayer expect to incur these costs more than once during the asset’s class life or if building, more than once during 10-yr period?
  - YES
  - NO

Routine Maintenance Safe Harbor does not apply

Deductible Expense
Routine Maintenance and Safe Harbor

Example: Building

• Investor purchases a shopping mall in 20X2
• When the shopping mall was placed in service, Investor expected to replace escalator handrails every four years.

- Escalator handrails replaced in year 4
- The cost is DEDUCTIBLE under the routine maintenance safe harbor
Casualty Loss Rule

Restorations

• Elective casualty loss or current-year repair deduction has been removed

• Amount required to be capitalized as a restoration of damage to a UOP is limited to the excess of
  
  – The adjusted basis in the single identified property at the time of the casualty over

  – Amount paid for the restoration of damage to the UOP from the casualty that would otherwise be a capital improvement

• Total deduction between the section 165 casualty loss and repairs cannot exceed out-of-pocket costs incurred in the year of the casualty event
Improvements to Property Industry Concerns

• Look for opportunities to apply the routine maintenance safe harbor to activities performed more than once in a 10-year period

• Identify real property remodel, refresh, and renovation activities may be deductible repair or maintenance, e.g. retail store refresh, office “restack”

• Consider filing accounting method change to apply repair and maintenance standards to prior years to accelerate deductions to the current tax year

• Consider electing to follow book capitalization methods for simplicity
Dispositions of Property
Dispositions

Overview of Proposed Regulations

• Regulations issued in proposed form
• Comments must be received by November 12, 2013
• May be relied upon for the 2012 and 2013 tax years
• IRS and Treasury Department intend to publish final regulations in 2013 - the final regulations are expected to apply to tax years beginning on or after January 1, 2014
Disposition

A disposition of property occurs when the asset’s ownership is transferred or when the asset is permanently withdrawn from use either in the taxpayer’s trade or business or in the production of income.

A disposition occurs when an asset is:

- Sold or exchanged;
- Retirement;
- Physically abandoned;
- Destruction (including casualty);
- Transferred to a supplies, scrap, or similar account;
- Involuntary conversion; or
- Disposition of a portion of an asset as a result of a casualty event, like-kind exchange, involuntary conversion, sale of a portion or an asset, or a “partial disposition” election.
Partial Disposition Election

- Taxpayers may *elect* to treat a partial disposition of an asset as a disposition
- Taxpayer claims a loss upon the disposition of a structural component (or a portion thereof) of a building without identifying the component as an asset before the disposition event
- The election is made on a timely filed return “including extensions” in the taxable year in which the disposition occurs
- Partial disposition rule is mandatory in certain cases (casualty event, like-kind exchange, involuntary conversions)
- Proposed regulations provide simplified method for determining adjusted basis of disposition, including discounted replacement cost, replacement cost of partial disposition as a percentage of replacement cost, cost segregations. There no longer is a consistency requirement
- Amend return or method change for 2012 and 2013
General Asset Account ("GAA")

Election

- Under the GAA, no loss on disposition recognized until all assets in the GAA have been disposed
- Definition for qualifying disposition more restrictive - limited to partial or complete disposition by casualty, charitable contribution, termination or sales of business, and certain non-recognition transactions
- Use of GAA returns to prior law
- Do NOT make a GAA election if goal is to claim losses on partial replacements, including building structural components
Other Considerations
Other Considerations

ASC 740

- Regulations are new law, record effects as of the enactment date: September 13, 2013
- Is the company required or choosing to file a method change with a section 481(a) adjustment? If so, consider if there is a:
  - Material deferred reclassification? When?
  - Change to the scheduling of depreciation?
  - Change to a valuation allowance
- Are there new book/tax differences to record in the 2014 provision, 2012 or 2013 if adopting early
  - Repair and maintenance
  - Excess de minimis expenses
- Are there new uncertain tax positions that need to be recorded?
  - Prior repair and maintenance study not in conformity
  - Company chooses to do nothing
  - De minimis policy in excess of $5,000 or $500; Prove it is clear reflection of income
Other Considerations (continued)

- File accounting method changes to obtain audit protection
- Deliverables and supporting documentation are required for IRS exam purposes
- Consider the use of statistical sampling where data is voluminous
- IRS will expect revisions to a previously filed repair method change
- Must consider the impact of Sec. 263A
- Additional industry guidance anticipated: Retail, Cable, Electric Generation, others likely
Next Steps

- Establish a timeline for 2014 tax year compliance
- Determine if current methods are compliant with the final regulations
- Quantify and document Uncertain Tax Positions or potential tax savings
- Discuss with financial statement auditors their expectations for documenting compliance
- Develop sustainable processes and procedures to continue for future tax years
- Consider filing favorable accounting method changes prior to 2014
  - Disposition of property
  - Repair and maintenance
- Await finalization of disposition method changes and Revenue Procedures with accounting method guidance
Elections and Method Changes
# Elections and Method Changes

<table>
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<tr>
<th>Issue</th>
<th>Report on the Tax Return</th>
<th>Attach an Annual Election to the Tax Return</th>
<th>Accounting Method Change</th>
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<tr>
<td>De Minimis Policy</td>
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<td>X</td>
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<tr>
<td>Book Capitalization Policy</td>
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<td>X</td>
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<tr>
<td>Safe Harbor for Small Taxpayers</td>
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<td>Partial Disposition</td>
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<td>X</td>
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<tr>
<td>Capitalization vs. Repairs</td>
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<tr>
<td>Disposition of a Component of a Building</td>
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<td>X - under temp. regs.</td>
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<td>Materials and Supplies</td>
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<tr>
<td>Annual Election to Capitalize and Depreciate Rotable and Temporary Spare Parts</td>
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<td>X</td>
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Significant Differences in Final and Proposed Regulations
### Significant Differences in Final and Proposed Regulations

<table>
<thead>
<tr>
<th>Issue</th>
<th>Temporary Regulations</th>
<th>Final Regulations</th>
</tr>
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<tbody>
<tr>
<td>Definition of a material and supply</td>
<td>A unit of property of $100 or less</td>
<td>A unit of property of $200 or less</td>
</tr>
<tr>
<td>Materials and supplies interaction with the de minimis election</td>
<td>Taxpayer can elect to include materials and supplies under the de minimis rule</td>
<td>If taxpayer elects the de minimis safe harbor, then all materials and supplies that fit within the rule must be included under the de minimis safe harbor</td>
</tr>
<tr>
<td>Election to capitalize materials and supplies</td>
<td>May elect to capitalize any material and supply</td>
<td>May elect to capitalize only rotatable, temporary or standby emergency spare parts (new category)</td>
</tr>
<tr>
<td>De minimis safe harbor</td>
<td>Only permitted if:</td>
<td>Only permitted if:</td>
</tr>
<tr>
<td></td>
<td>• Written policy at beginning of the tax year</td>
<td>• Written policy at beginning of the tax year</td>
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<td></td>
<td>• Amount expensed for books pursuant to the policy</td>
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<td>• Have an AFS</td>
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<td></td>
<td>• Total amount expensed less than: .1% tax gross receipts or 2% of book depreciation and amortization</td>
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## Significant Differences in Final and Proposed Regulations (continued)

<table>
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<tr>
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</table>
| Routine Maintenance Safe Harbor       | • Permitted if the taxpayer reasonable expects to perform maintenance on the property more than once over the ADS class life of the property  
• Not permitted for real property     | • Extends the routine maintenance safe harbor to real property                           
• Permitted if the taxpayer reasonably expects to perform maintenance on the building (or building system) more than once during a 10-year period |
| Small Taxpayer Safe Harbor Election   | None                                                                                    | • Taxpayers with average annual gross receipts of $10M or less may elect not to apply the capitalization provisions with respect to an eligible building  
• An eligible building is a building that is owned or leased and that has an unadjusted basis of $1M or less  
• The total amount paid during the taxable year for repairs, maintenance, and improvements cannot exceed the lesser of 2% of the unadjusted basis of the building or $10,000  
• The election is irrevocable         |
| Election to Capitalize                | None                                                                                    | Annual election to capitalize otherwise deductible repairs that are capitalized for books                                                      |
### Significant Differences in Final and Proposed Regulations (continued)

<table>
<thead>
<tr>
<th>Issue</th>
<th>Temporary Regulations</th>
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</table>
| Dispositions| • Mandatory recognition of gain/loss for disposition of structural components of a building  
             • Taxpayers could elect to use GAA to have flexibility in choosing to deduct loss on the disposition or costs of deductible repairs  
             • Use of any reasonable method to determine basis | • Treat building, not the structural components, as the asset for disposition purposes  
             • Optional annual election to recognize gain/loss on partial dispositions of assets  
             • Partial disposition election does not apply to dispositions of entire assets  
             • Alternative methods for determining the portion of basis attributable to a component  
             • Election most flexible for non-GAA assets |
| GAA         | Qualifying dispositions definition expanded to include retirement of a structural component of a building | Qualifying dispositions definition no longer includes the retirement of a structural component of a building |
Questions and Answers
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