

AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

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FEDERAL TAX



SUBJECT

IRS RELEASES AUDIT TECHNIQUE GUIDE: CAPITALIZATION OF TANGIBLE PROPERTY, §1.263(A)

SUMMARY

The IRS issued [its LB&I Capitalization of Tangible Property Audit Technique Guide](#) (“ATG”) in September, 2016, as a tool for IRS examiners to use for identifying potential tax issues associated with §1.263(a) and related regulations (“Regulations”). The ATG provides the evolutionary history of the Regulations, overview of the purpose of the Regulations, IRS examination considerations as well as a general discussion of the numerous areas covered by the Regulations.

While the ATG does not provide much new information, it is illustrative for understanding how the IRS will examine tax issues associated with the Regulations. The ATG, 18 chapters spanning 202 pages, provides an overview of the major areas of the Regulations, potential audit issues, how agents are to address prior capitalization studies, audit risk areas and scope, interview questions, and tax treatment of related areas, e.g. §199 deductions, §263A inventory and self-constructed property, and Alternative Minimum Tax, among others.

DETAILS

The introductory discussion of the ATG highlights relevant case law and guidance influential to the drafting of the Regulations, including the history of the versions of the Regulations (e.g. proposed, temporary, etc.) leading up to finalization of the Regulations. For quick reference, the ATG includes a useful glossary of terminology commonly used throughout the Regulations and ATG. It also identifies a variety of compliance considerations, such as which version of the Regulations were relied upon for implementation of method changes, review of repair studies, the 2012 LB&I “stand-down,” use of statistical

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sampling, industry specific guidance, examination considerations, and interview questions.

The remaining chapters of the ATG are subdivided by topics as follows:

- ▶ Unit of Property
- ▶ Amounts Paid To Acquire Or Produce Property
- ▶ De Minimis Safe Harbor
- ▶ Improvement Rules - Betterment, Restoration, New Or Different Use
- ▶ Safe Harbors, Special Rules, And Other Provisions
- ▶ Materials And Supplies
- ▶ Leased Property
- ▶ Dispositions
- ▶ General Asset Accounts
- ▶ Accounting Method Changes

Each chapter includes an explanation of the chapter's context and the general rules, provided in plain language, sometimes with examples. Several examples in the ATG supplement the many examples in the Regulations and give additional insight into making the subjective determination of whether an expenditure is a capital improvement or a deductible repair. The Audit Procedures section of each chapter identifies recommended documents IRS Agents should consider for review, specific areas of audit risk, and detailed examination considerations, such as costs that have been deducted or capitalized, whether the repair definition has changed, which elections were made, evaluation of repair/improvement work order systems, project tracking, and documentation.

Throughout the ATG there are explanations of the interrelated nature of the varying areas of the Regulations and accounting method changes. For example, the application of the routine maintenance safe harbor, replacement of separate assets, disposition of components, and partial disposition elections can each have bearing on whether to capitalize an expenditure and whether a gain or loss on disposition may be recognized. The ATG provides guidance to IRS examiners on navigating the interplay of the various accounting methods, elections, and safe harbors provided in the Regulations.

A significant portion of the narrative in the ATG is also given to the timing of when the method changes were filed, under which version of the regulations, under which Revenue Procedure guidance, and whether method changes were filed and then refiled. All of these factors are addressed in the ATG and provide instruction to Agents regarding the application of the Regulations, to accounting methods taxpayers may or may not have adopted through accounting method changes.

Subjectivity Remains

The Regulations provide many examples to illustrate how the Regulations are to be applied. However, in a number of areas, the examples in the Regulations are not as complete as some may like to provide a high degree of certainty of whether an expenditure is to be capitalized or deducted. Yet, despite the length of the ATG, there are still areas of significant subjectivity left to IRS Agents and Taxpayers to address on a factual case-by-case basis. For example, if a Taxpayer's de minimis expensing amount is greater than the allowed thresholds (\$2,500/\$5,000), Agents are not instructed to negotiate whether the policy "clearly reflects income." The ATG instructs that the taxpayer must provide the burden of proof. Likewise, IRS Agents are not given any additional guidance to determine whether an expenditure is a "material increase in productivity, efficiency, strength, quality, or output" for purposes of identifying a betterment. The ATG simply provides that this is fact-dependent for each case and the Agent must consider the purpose of the work, physical nature of the work performed, and physical effect of the work on the UOP.

Taxpayers entering IRS Examinations should expect the IRS to audit their implementation of the Regulations. It is also wise to be prepared to support any method changes filed to implement the Regulations or, in the alternative, support their current methods, justifying with support why method changes were not filed.

BDO INSIGHTS

The following recommendations are provided to enable you to begin preparing for an IRS examination related to the tangible property regulations.

- ▶ Use the ATG as a roadmap for understanding how IRS agents will approach audit issues related to the tangible property regulations.
- ▶ For taxpayers that have already implemented the Regulations, verify that method changes were made to a proper method of accounting and that method changes were filed properly under the appropriate Revenue Procedure(s).
- ▶ Prepare for IRS exams by assessing your documentation of the adoption of the Regulations, evaluating identified audit risk areas, and addressing potential questions IRS examiners may ask.
- ▶ Taxpayers that find that their accounting methods, documentation, or past repair studies are lacking should bolster support in anticipation of IRS exams.

The Accounting Methods group within BDO USA's National Tax Office has extensive experience assisting taxpayers of all industries and sizes with their accounting method issues, filing accounting method change requests, and navigating IRS examinations of accounting method changes. Please contact a BDO professional if you would like to discuss how BDO can assist you with an accounting method or IRS exam issue.

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