



# Final Tangible Property Regulations

**December 5, 2013**

Alison Pinnel  
Tax Director  
Deloitte Tax LLP  
[apinnel@deloitte.com](mailto:apinnel@deloitte.com)





# Final Tangible Property Regulations

**December 5, 2013**

Alison Pinnel  
Tax Director  
Deloitte Tax LLP  
[apinnel@deloitte.com](mailto:apinnel@deloitte.com)

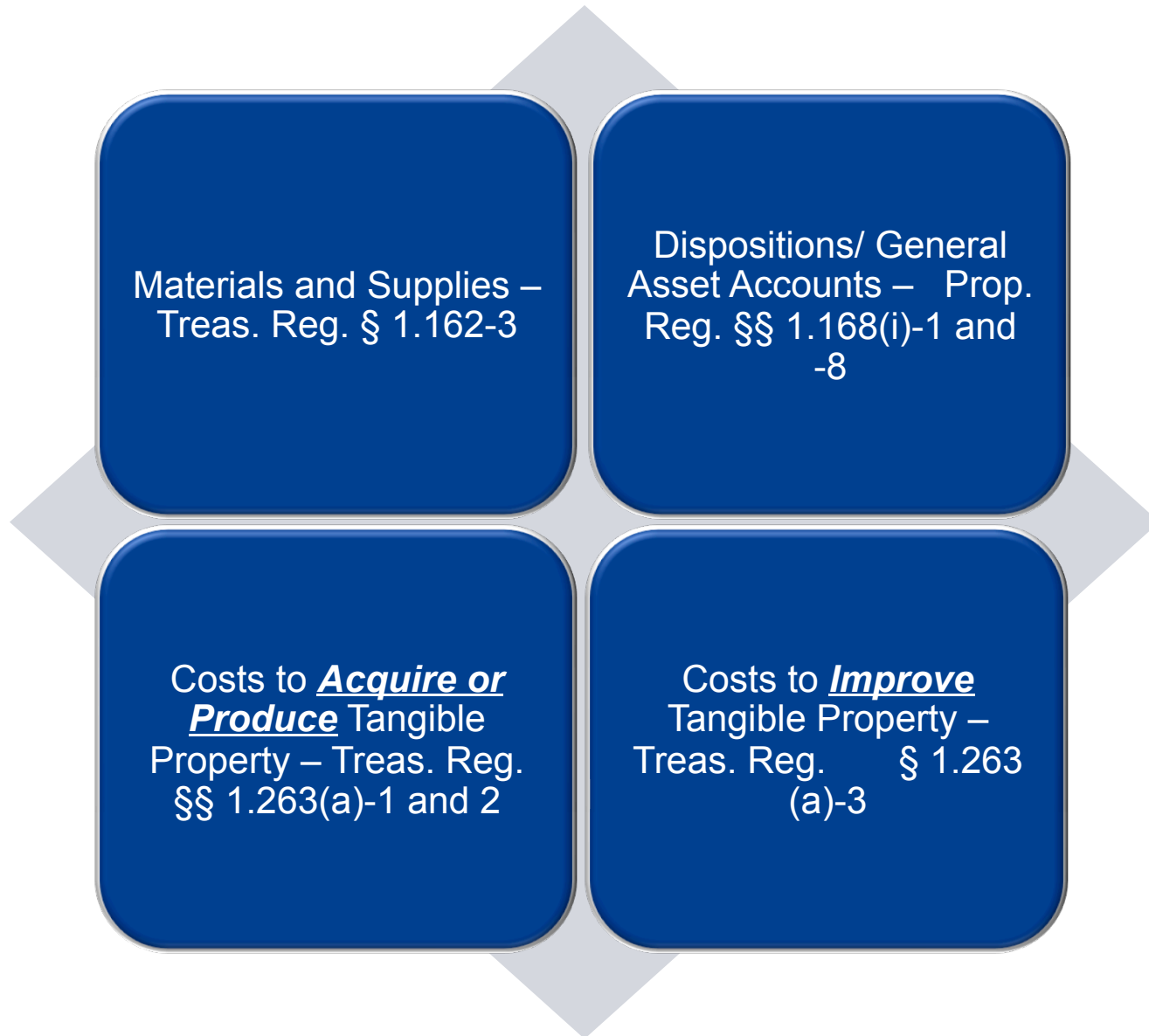


# Agenda

Topic
Overview
Effective Dates & Transitional Guidance
Final Regulations
Re-Proposed Regulations
Additional Considerations
Questions

# Overview

# General Framework



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

**Companies will  
need to make  
elections**

**Companies will likely need  
to file accounting method  
changes**

**Very limited book  
conformity**

**There will likely be a  
financial statement  
impact**

# Effective Dates & Transitional Guidance

# Effective Dates and Transitional Guidance

- Final regulations are generally effective for taxable years beginning on or after January 1, 2014
- Special rules apply to amounts paid or incurred on or after January 1, 2014 for—
  - Materials and supplies
  - De minimis safe harbor
  - Costs to facilitate
- Taxpayers may early adopt the final regulations for taxable years beginning on or after January 1, 2012 (or, as applicable, for amounts paid or incurred in taxable years beginning on or after January 1, 2012)
  - Certain elections (e.g., de minimis safe harbor, small taxpayer safe harbor) may be made on an amended return for a tax year beginning on or after January 1, 2012 and ending before September 19, 2013
- Procedural guidance for adopting the final and new proposed regulations anticipated in late October/early November



# Final Regulations

# Materials and Supplies – Treas. Reg. § 1.162-3

- A material and supply is tangible property 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 tangible property;
  - Fuel, lubricants, water, or similar items that are reasonably expected to be consumed in 12 months or less;
  - A unit of property that has an economic useful life of 12-months or less;
  - A unit of property with an acquisition or production cost **\$200 or less**; or
  - Property identified in future published guidance
- Available methods:
  - If incidental, deduct when purchased
  - If non-incidental, deduct when used or consumed
  - Special rules for rotatable/temporary spare parts
    - Optional method
    - **Annual election to capitalize**
- **Special rules apply if taxpayer makes the de minimis safe harbor election**

# Materials and Supplies - Considerations

- Generally a GAAP “book” - capital item (think de minimis)
- If “supply” assess whether incidental or non-incidental
- Differences between 2011 Temporary Regulations and 2013 Final Regulations
  - Election to capitalize
  - \$200
  - Rotable and emergency spare parts
- “What’s the big deal....seems trivial?”
- Method changes, elections and the future

# De Minimis Safe Harbor Election – Treas. Reg. § 1.263(a)-1(f)

## Taxpayers with an AFS

- Written capitalization policy 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 AFS according to written policy
- Amount paid for the property does not exceed **\$5,000** per invoice (or per item, if substantiated on the invoice)

## Taxpayers without an AFS

- Accounting procedures 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 books and records according to accounting procedures
- Amount paid for the property does not exceed **\$500** per invoice (or per item, if substantiated on the invoice)

# De Minimis Safe Harbor Election

- De minimis safe harbor election does not apply to inventory, land or rotatable spare parts accounted for under the optional method
- AFS definition clarified to include members of financial consolidated group (e.g., partnerships, CFCs)
- Transaction and additional costs (e.g., delivery fees, installation costs, and similar items) included in amount paid for property if included on the same invoice as the property
- Can allocate lump-sum fees to multiple invoice items
- Materials and supplies that fit under election are accounted for under such election and not as materials and supplies

## De Minimis Safe Harbor Election (cont.)

- Annual, irrevocable election made on timely-filed (including extensions) original return
  - Title should read “Section 1.263(a)-1(f) de minimis safe harbor election”
  - Attached to timely filed original return (including extensions)
  - Made for each member of the consolidated group by the common parent
  - Made at the S corporation or partnership level, not by shareholders or partners
- Election on amended return for 2012
  - Election made on amended return for tax year beginning on or after January 1, 2012, and ending on or before September 19, 2013
  - Election must be made on amended return filed within 180 days of the extended due date of the originally-filed return (whether or not taxpayer extended the return)

# De minimis Safe Harbor Election Considerations

- Does the taxpayer have an applicable financial statement?
- Does the taxpayer have a written capitalization policy?
  - Does the policy provide for the expensing of amounts that exceed the \$5,000 safe harbor threshold?
  - Have these amounts historically been subject to exam?
- In what g/l accounts are the relevant amounts recorded?
  - Expensed purchases
  - Materials and supplies
  - Repairs
- Information available to substantiate that bulk purchases fall under the safe harbor threshold?

## Amounts Paid to Improve Tangible Property – Treas. Reg. § 1.263(a)-3

Determine  
the unit of  
property

Apply the  
improvement  
standards

Consider the  
routine  
maintenance  
safe harbor

Consider  
capitalization  
election

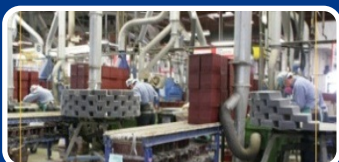


# Determine the Unit of Property – Treas. Reg. § 1.263(a)-3 (e)-(f)



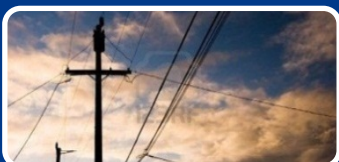
## Buildings

- Each building and its structural components is a UoP
- Improvement standards are applied at the building & building system level



## Plant Property

- Functional interdependence is relevant
- Discrete and major function standard must be applied



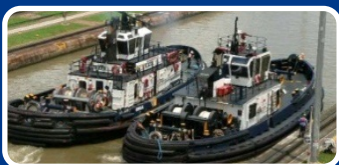
## Network Assets

- Based on facts and circumstances or as provided in published guidance
- Functional interdependence test not determinative



## Leased Property

- Each building and its structural components (*lessor*) or the portion of each building subject to the lease and the structural components associated with the leased portion (*lessee*)
- Improvement standards are applied to the portion of the building & building systems subject to the lease (lessee)



## Other Property

- Functional Interdependence
- Facts & circumstances

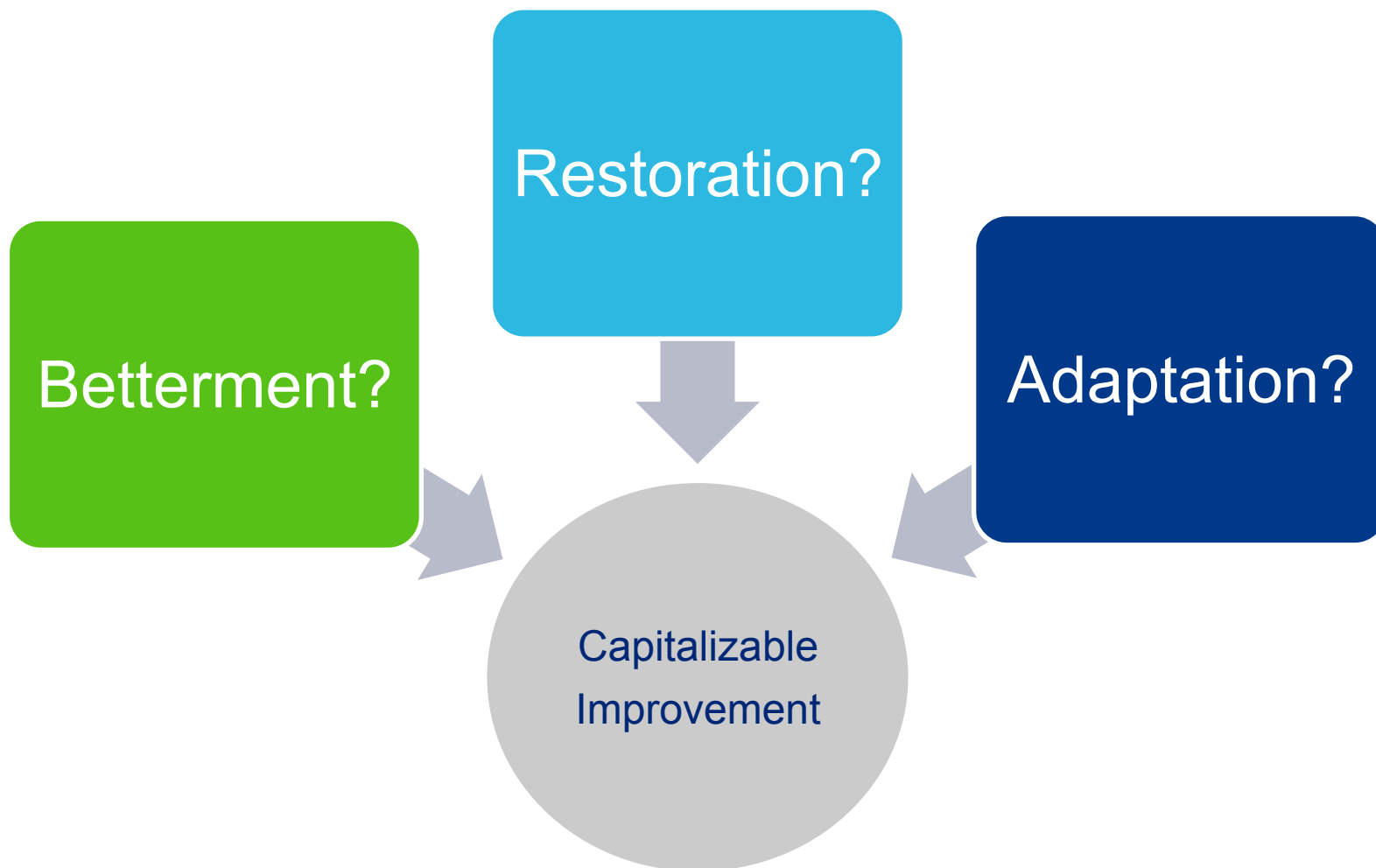
# Determining the Unit of Property - Considerations

- What are the current tax units of property for improvement purposes?
  - Does the taxpayer treat the building structure and building systems as separate UoPs?
  - Does the taxpayer treat industrial plant property components that perform discrete and major functions as separate UoPs?
  - How does the taxpayer handle leased property?
- Is the taxpayer's fixed asset system capable of identifying separate UoPs?
- Who determines UoPs of tax purposes?

## Apply the Improvement Standards– Treas. Reg. § 1.263(a)-3(g)

- Must capitalize all direct costs of the improvement
- Must capitalize indirect costs that directly benefit or are incurred by reason of the improvement
- Includes amounts paid over more than one tax year
- Compliance with regulatory requirements is not relevant in determining whether the amount paid improves the UoP
- Removal costs are not capitalized if the taxpayer has taken into account the adjusted basis of the removed asset or component of the asset in computing gain or loss

## Apply the Improvement Standards – Treas. Reg. § 1.263 (a)-3



## Betterment – Treas. Reg. § 1.263(a)-3(j)

### Betterment:

- Corrects a material defect existing prior to the taxpayer's acquisition of the UoP or one that arose during the production of the UoP;
- Is for a material addition (e.g., physical enlargement, expansion, extension, or addition of a major component) to the UoP; or
- Is reasonably expected to materially increase the strength, productivity, efficiency, quality, or output of the UoP

# Betterment Examples

## Improvement

- Costs to remediate soil contamination that existed prior to the purchase of a store/land
- Costs to remodel and upgrade retail stores to compete in a new store class
- Costs to add insulation to a building that reduces annual energy and power costs by 50%
- Costs to disassemble, move, reconfigure, and add components to manufacturing equipment that increase the capacity of the equipment

## Repair and Maintenance

- Costs for scheduled routine maintenance of equipment that addresses minor conditions/defects from prior owner's use
- Costs to refresh retail stores to keep the stores in ordinary efficient operating condition
- Costs to replace 2 of 10 RTUs within a building's HVAC system, which eliminates climate control problems and increases energy efficiency by 10%
- Costs to relocate cash registers from one retail location to another retail location upon expiration of lease for original location

## Restoration – Treas. Reg. § 1.263(a)-3(k)

### Restoration:

- Replacement of a component of a UoP for which the taxpayer has properly deducted a loss
- Replacement of a component of a UoP and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss
- Restoration of damage to a UoP for which the taxpayer is required to adjust basis as a result of a casualty
- Returns the UoP to its ordinarily efficient operating condition if the property has deteriorated to a state of nonfunctional disrepair
- Rebuilding of the UoP to a like-new condition after the end of its class life
- Replacement of a part or a combination of parts that comprise a **major component** or a **substantial structural part** of a UoP

# Major Component/Substantial Structural Part Examples

## Major Component/Substantial Structural Part

- Engine and cab of truck tractor
- Petroleum tank of trailer
- Underground storage tanks of a retail gasoline pumping system
- Entire roof of a manufacturing building (including decking, insulation, asphalt, and various coatings)
- Chiller unit in office building HVAC system (e.g., chiller, boiler, pumps, duct work, diffusers, air handlers, outside air intake, cooling tower)
- Sprinkler system within an office building fire protection and alarm system
- All wiring within a building's electrical system

## Not a Major Component/Substantial Structural Part

- Power switch assembly of drill press
- Waterproof membrane of retail store roof (comparable to original membrane)
- 1 of 3 furnaces in an office building HVAC system (i.e., 3 furnaces, 3 a/c units, duct work)
- 3 of 10 rooftop units in an office building HVAC system (i.e., 10 RTUs, system controls, duct work)
- 30% of the wiring within a building's electrical system



# Major Component/Substantial Structural Part Examples (cont.)

## Major Component/Substantial Structural Part

- All toilets and bathroom sinks (not including the associated piping) in all restrooms in 3-floor retail building
- All bathtubs, all toilets, and all sinks in hotel guest rooms composing 2 of 20 hotel floors as part of a 3-year program to replace the same in all hotel guestrooms
- 200 of 300 exterior windows
  - 300 windows represent 25% of building surface area
- 100 of 300 exterior windows
  - 300 windows represent 90% of building surface area
- Wood floors in all public areas of a hotel
  - Public areas represent 40% of hotel square footage

## Not a Major Component/Substantial Structural Part

- Power switch assembly of drill press
- Waterproof membrane of retail store roof (comparable to original membrane)
- 1 of 3 furnaces in an office building HVAC system (e.g., 3 furnaces, 3 a/c units, duct work)
- 3 of 10 rooftop units in an office building HVAC system (e.g., 10 RTUs, system controls, duct work)
- 30% of the wiring within a building's electrical system

## Adaptation – Treas. Reg. § 1.263(a)-3(I)

### Adaptation:

- Modification of a unit of property that is not consistent with the taxpayer's intended ordinary use of the unit of property at the time the property was placed in service

# Is an expenditure an improvement?

- What is the taxpayer's book capitalization policy?
  - Who determines (and based on what criteria) whether an expenditure is a repair or capitalizable improvement? Operations/engineering? Fixed asset personnel? Tax?
  - How do these criteria align with definitions of betterment, restoration, adaptation in the final regulations?
- Are the taxpayer's systems able to track basis recovery events (e.g., casualty loss, retirement, restoration of property from nonfunctional state of disrepair, etc.)?
- Does the taxpayer have a mechanism to determine whether an expenditure is to rebuild a UoP to like-new condition or to replace a major component?

## Consider the Routine Maintenance Safe Harbor – Treas. Reg. § 1.263(a)-3(i)

Amount paid is deemed to *not* improve the unit of property 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 unit of property in its ordinarily efficient operating condition

- Routine maintenance is an activity that the taxpayer reasonably expects (at the time the property is placed in service) to perform more than once during the ADS class life of the UoP
  - For buildings (structural components thereof) and building systems, taxpayer must reasonably expect to perform activities more than once during 10-year period from placed in service date
  - Consider and document the recurring nature of activity, taxpayer's experience, manufacturer recommendations, and industry practice
- Only applies to amounts otherwise capitalized as restorations on account of rebuilding a UoP to like-new condition or replacing a major component or substantial structural part of a UoP (i.e., does not apply to betterments or other types of restorations)
- Does not apply to network assets or certain rotatable spare parts

# Routine Maintenance Safe Harbor Examples

- Aircraft with 12-year class life
  - Engine shop visits [e.g., disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts] expected to occur every 4 years
  - Engine shop visit performed in year 15 on original aircraft engine does not result in an improvement
- Lined containers used in production process with 12-year class life
  - Lining replacement expected to occur every 3 years
  - Lining is a substantial structural part (60% of container structure)
  - Replacement of lining in years 4, 7, 9, and 12 does not result in an improvement
- Building HVAC system
  - Testing, monitoring, and preventative maintenance expect to occur every 4 years
  - Scheduled maintenance in years 4 and 11 does not result in an improvement even though scheduled maintenance was not actually performed twice during 10-year period

# Eligibility for the Routine Maintenance Safe Harbor

- How does the taxpayer capture costs that would be eligible for the routine maintenance safe harbor?
- Can the taxpayer determine whether an activity is reasonably expected to occur more than once during the ADS class life (10-year period for buildings)?
  - What type of support exists? Manufacturers' suggested maintenance information, industry practice, historic treatment for similar UoP?
  - How will the taxpayer record and track this information?

## Capitalization Election – Treas. Reg. § 1.263(a)-3(n)

- A taxpayer may elect to capitalize amounts paid during the taxable year for repair and maintenance of tangible property capitalized on its books and records
- Election applies to all amounts paid for repairs and maintenance capitalized on the taxpayer's books and records
- Amounts expensed on books and records subject to otherwise applicable Code and regulation provisions and must be analyzed accordingly
- Capitalized amounts depreciated beginning when placed in service
- Annual irrevocable election made by attaching statement to timely filed return for year election is to be effective

# Re-Proposed Regulations



# Disposition of MACRS Property – Prop. Reg. § 1.168(i)-8

- Disposition is a transfer of ownership or permanent withdrawal from the trade or business of an asset, including:
  - Sale or exchange
  - Retirement
  - Physical abandonment
  - Destruction (including casualty)
  - Transfer to supplies, scrap, or similar account
  - Involuntary conversion
  - Disposition of a portion of an asset as a result of—
    - A casualty event;
    - A disposition for which gain is not recognized under sections 1031 or 1033;
    - A transfer described under section 168(i)(7);
    - A sale of a portion or an asset; or
    - A disposition for which the taxpayer has made a partial disposition rule election

## Partial Disposition Election – Prop. Reg. § 1.168(i)-8(d)(2)

- Taxpayers may elect to recognize gain or loss upon partial disposition of an asset
- The election is made in the taxable year in which the disposition occurs
  - Late election may be made if on exam, repair deduction is recharacterized as capitalizable improvement
- Partial disposition rule is mandatory for—
  - Partial dispositions as a result of a casualty event;
  - A disposition for which gain is not recognized under sections 1031 or 1033;
  - A transfer of a portion or an asset in a step-in-the-shoes transaction described in section 168(i)(7); or
  - A sale of a portion of an asset (even if no partial disposition rule election is made)
- Special rules apply to assets to assets classified in asset classes 00.11 through 00.4 of Rev. Proc. 87-56

# Partial Disposition Election Example

**Taxpayer replaces 1 of 4 elevators in its office building. The office building (including its structural components) is the asset for disposition purposes.**

## No Partial Disposition Election

- The retirement of the replaced elevator is not a disposition
- Continue to depreciate the cost of the building (including the cost of the elevator and other structural components)
- Do not recognize a loss for the retired elevator
- If the replacement elevator must be capitalized as an improvement, the replacement elevator is a separate asset for disposition and depreciation purposes

## Partial Disposition Election

- The retirement of the replaced elevator is a disposition
- Depreciation of the retired elevator ceases at the time of retirement (taking into account the applicable convention)
- Recognize a loss for the retired elevator
- The replacement elevator must be capitalized as an improvement, and the replacement elevator is a separate asset for disposition and depreciation purposes

# General Asset Accounts (“GAA”) – Prop. Reg. § 1.168(i)-1

- Assets may be grouped into a single GAA if:
  - Same depreciation method (cannot combine bonus and non-bonus)
  - Same recovery period
  - Same convention (must be placed in service in same month, quarter, etc.)
  - Placed in service in same taxable year
- A single asset can be placed into a GAA
- Affirmative election in the year assets placed in service
- If GAA elected, no loss on disposition recognized until all assets in GAA are disposed
  - Limited availability of qualifying disposition election
  - Must elect to recognize gain/loss on disposition of all or last asset in GAA
- Special rules for partial dispositions of assets included in a GAA

# Disposition Considerations

- How does the taxpayer treat retirements for book purposes?
  - Does tax follow book?
- Does the taxpayer's fixed asset system contain the necessary information to claim partial dispositions?
  - How will the taxpayer identify partial dispositions?
  - What methodology(ies) will the taxpayer employ to determine the adjusted basis of partial dispositions?
- Does the taxpayer have difficulty tracking dispositions of entire assets?
  - Will the taxpayer benefit from making a GAA election?

# Additional Considerations

# Complying with the Final and Re-Proposed Regulations

- Certain provisions will require accounting method changes; other provisions are elective
  - How will taxpayers that adopted provisions in the 2011 Temporary Regulations transition to the final and re-proposed regulations?
- Determining when to comply with the final regulations
  - Favorable vs. unfavorable provisions
  - Section 481(a) vs. cut-off/modified cut-off
  - Making annual elections
    - Certain elections can be made on amended returns for tax years beginning on or after January 1, 2012, and ending on or before September 19, 2013
    - Anticipated procedural guidance may provide for limited retroactive elections in certain cases

# Additional Considerations

- ASC 740 implications
- Tax return signing
- Impact of prior or current year transactions
  - Section 351 / Section 721
  - Section 381(a)
  - Section 1031



Questions?



**About Deloitte**

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.com/about](http://www.deloitte.com/about) for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2013 Deloitte Development LLC. All rights reserved.

Member of Deloitte Touche Tohmatsu Limited

This presentation contains general information only, and Deloitte is not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this presentation.