

# Final IRS Repair Regulations: What You Need to Know Now

Tax Planning and Compliance After Substantial Changes to 263(a) Cost Capitalization Rules

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Today's faculty features:

Christian Wood, Tax Senior Manager, **Eide Bailly**, Minneapolis

Leslie J. Schneider, Partner, **Ivins Phillips & Barker**, Washington, D.C.

David Strong, Director, **Crowe Horwath**, Grand Rapids, Mich.

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# Final IRS Repair Regulations: What You Need to Know Now

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November 7, 2013

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Leslie J. Schneider, Ivins, Phillips & Barker

[LSchneider@ipbtax.com](mailto:LSchneider@ipbtax.com)

Christian Wood, Eide Bailly

[cwood@eidebailly.com](mailto:cwood@eidebailly.com)

David Strong, Crowe Horwath

[david.strong@crowehorwath.com](mailto:david.strong@crowehorwath.com)

# Today's Program

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New Repair Regulations <i>[Leslie J. Schneider]</i>	Slide 7 - Slide 18
Acquisition Costs <i>[Christian Wood]</i>	Slide 19 - Slide 27
<i>Materials and Supplies</i> <i>[Christian Wood]</i>	Slide 28 - Slide 39
<i>Improvements to Tangible Property</i> <i>[Dave Strong]</i>	Slide 40 - Slide 58
<i>Disposition of Tangible Property</i> <i>[Dave Strong]</i>	Slide 59 - Slide 62
<i>Procedural Issues</i> <i>[Leslie J. Schneider]</i>	Slide 63 - Slide 64

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Leslie J. Schneider  
Ivins, Phillips & Barker Chartered  
Washington, D.C.

October 17, 2013

# **NEW REPAIR REGULATIONS**

# HOW TO APPROACH THE NEWLY-ISSUED REGULATIONS

1. Does the taxpayer want to comply mainly prospectively?
2. Alternatively, is the taxpayer seeking negative section 481(a) adjustments by searching through prior years' transactions to look for opportunities to expense previously capitalized repairs and claim losses on dispositions of components of units of property?
3. Does the taxpayer want to be aggressive in claiming repair deductions and will the financial side of the taxpayer go along with that approach, even though this approach may reduce book earnings?

# HOW TO APPROACH THE NEWLY-ISSUED REGULATIONS (CONT.)

4. Is the taxpayer willing to deal with the complexity of having Schedule M adjustments and maintaining separate adjusted basis and depreciation records for depreciable property for book and tax purposes?

How you answer these four questions should guide your approach to complying with the new regulations and help you make the right choice of elections.

# **ALTERNATIVE ONE – TAXPAYER MAINLY WANTS TO COMPLY PROSPECTIVELY.**

- 1.** While compliance with the regulations, except for a few special elections, constitutes a change in method of accounting and requires the filing of a Form 3115 and the calculation of a section 481(a) adjustment, if the adjustment is likely to be favorable to the taxpayer, it is doubtful that the IRS will care if a taxpayer fails to claim the adjustment.
- 2.** There is language in the preamble suggesting that the IRS will be flexible.

## **ALTERNATIVE ONE – TAXPAYER MAINLY WANTS TO COMPLY PROSPECTIVELY. (CONT.)**

- 3.** However, the Treasury did not want to officially sanction the election of a cut-off transition method for these regulations because for some taxpayers, the section 481(a) adjustment would be positive (i.e., increase in taxable income).
- 4.** If a taxpayer wants to adopt this cut-off approach, make sure the net effect of the regulations on the taxpayer's existing methods is net favorable and that any section 481(a) adjustment would be favorable to the taxpayer, if one were calculated. You can determine this by comparing the taxpayer's present treatment of transactions with the rules in the new regulations.

## **ALTERNATIVE TWO – TAXPAYER LOOKING FOR NEGATIVE SECTION 481(A) ADJUSTMENT**

- 1.** A detailed study of prior years' repair and capital transactions needs to be performed. Consider the availability of records.
- 2.** Careful consideration needs to be given as to the scope of review of prior years' repair and improvement transactions. The new regulations are not 100% favorable to taxpayers and an incomplete review that focuses exclusively on favorable changes may not satisfy the IRS.

## ALTERNATIVE TWO – TAXPAYER LOOKING FOR NEGATIVE SECTION 481 (A) ADJUSTMENT (CONT.)

3. Even though the proposed regulations suggest that a cut-off method must be used in claiming deductions for dispositions of a portion of a unit of property (i.e., the roof on a building), Treasury has indicated flexibility and may allow section 481 (a) adjustment when the new revenue procedures are issued, sometime in November.
4. Statistical sampling and extrapolation may be needed.

## **ALTERNATIVE THREE - TAXPAYER WANTS TO AGGRESSIVELY SEEK OUT REPAIR DEDUCTIONS.**

- 1.** Taxpayer needs to consider whether the financial accounting side of the business will go along with this approach.
- 2.** This will require close coordination with financial accounting personnel within the company.
- 3.** The regulations contain many elections that will accelerate deductions, but will financial reporting go along with using all of these elections?

**ALTERNATIVE THREE – TAXPAYER WANTS TO  
AGGRESSIVELY SEEK OUT REPAIR DEDUCTIONS.  
(CONT.)**

4. If the tax personnel or outside CPA does not want to be in the position of having to review every repair v. capital decision made by the financial accounting side of the company, the financial side of the company will need to be counseled on the new tax rules and educated on how to implement the new methods.

## **ALTERNATIVE FOUR – TAXPAYER WILLING TO CLAIM SCHEDULE M ADJUSTMENTS.**

- 1.** Don't make the overall book conformity election.
- 2.** However, book conformity is needed in order for a taxpayer to make the de minimis election for tax purposes.

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# ACQUISITION COSTS



# Acquisition Costs §1.263(a)-2(d)&(e)

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Amounts paid to acquire or produce a unit of real or personal property include:

- Invoice price;
- Transaction costs; and
- Costs for work performed prior to the date that the asset is placed in service by the taxpayer

Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property and must be capitalized.



# Acquisition Costs §1.263(a)-2(f)

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## Transaction Costs

- Amounts paid to facilitate the acquisition of real or personal property if paid in the process of investigating or otherwise pursuing the acquisition.
- Determined based on all of the facts and circumstances.
- The fact that the amount would (or would not) have been paid but for the acquisition is relevant but is not determinative.
- Amounts paid to facilitate an acquisition include, but are not limited to, inherently facilitative amounts.



# Inherently Facilitative §1.263(a)-2(f)(2)(ii)

An amount is inherently facilitative if the amount is paid for—

- Transporting the property (for example, shipping fees and moving costs);
- Securing an appraisal or determining the value or price of property;
- Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;
- Application fees, bidding costs, or similar expenses;
- Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);
- Examining and evaluating the title of property;



# Inherently Facilitative §1.263(a)-2(f)(2)(ii)

## Inherently facilitative Costs Continued—

- Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;
- Conveying property between the parties, including sales and transfer taxes, and title registration costs;
- Finders' fees or brokers' commissions, including amounts paid that are contingent on the successful closing of the acquisition;
- Architectural, geological, engineering, environmental, or inspection services pertaining to particular properties; or
- Services provided by a qualified intermediary or other facilitator of an exchange under §1031.



# Acquisition Costs §1.263(a)-2(f)(2)(iii)(A)

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## Special rule for acquisitions of real property-

- Except for inherently facilitative amounts, an amount paid by the taxpayer 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.



# Acquisition Costs §1.263(a)-2(f)(2)(iii)(B)

## Acquisitions of real and personal property in a single transaction.

- An amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of personal property facilitates the acquisition of such personal property even if such property is acquired in a single transaction that also includes the acquisition of real property.
- A taxpayer may use a reasonable allocation to determine which costs facilitate the acquisition of personal property and which costs relate to the acquisition of real property.



# Acquisition Costs §1.263(a)-2(f)(2)(iv)

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## Employee Compensation and Overhead Costs-

- Generally are not treated as amounts that facilitate the acquisition of property.
- Does not affect the application of §263A.
- May elect to capitalize
  - Employee Comp & Overhead elected separately.
  - Elect for each acquisition.
  - Elect by treating on timely filed original Federal tax return.

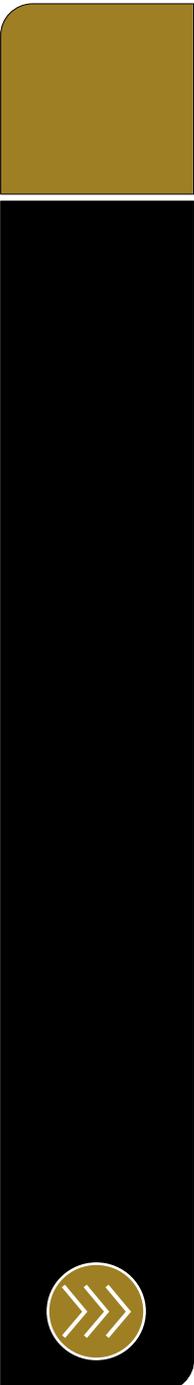


# Acquisition Costs §1.263(a)- 2(f)(3)(iii)

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A contingency fee is an amount paid that is contingent on the successful closing of the acquisition of real or personal property. Contingency fees must be included in the basis of the property acquired and may not be allocated to the property not acquired.





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# MATERIALS AND SUPPLIES

# Materials & Supplies

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



# Materials & Supplies

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## Economic useful life:

- The period over which the property may reasonably be expected to be useful to the taxpayer.
- Useful life used in Applicable Financial Statements (“AFS”).



# Applicable Financial Statement

AFS are, in descending level of priority-

- A. A Financial Statement required to be filed with the SEC;
- B. A certified audited FS that is accompanied by the report of an independent CPA, that is used for-
  - 1. Credit purposes;
  - 2. Reporting to shareholders, partners, or similar persons; or
  - 3. Any other substantial non-tax purpose; or
- C. A Financial Statement (other than a tax return) required to be provided to the Federal or a state government or any Federal or state agencies (*other than the SEC or the Internal Revenue Service*).



# *De minimis* Rule

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- Allows taxpayer to substitute its threshold for capitalization for a specified dollar amount and economic useful life.
- If elected, must treat all tangible property that qualifies under the *De Minimis* rule.
- Generally deducted in the taxable year the amount is paid or incurred.
- Requires a statement for each year elected.



# *De minimis* Rule

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Does not apply to:

- Inventory property;
- Land;
- Rotable, temporary, and standby emergency spare parts that the taxpayer elects to capitalize; and
- Rotable and temporary spare parts that the taxpayer accounts for under the optional method of accounting for rotatable parts.



# Taxpayer's with AFS

- The taxpayer has at the beginning of the taxable year written accounting procedures treating as an expense for non-tax purposes--
  - Amounts paid for property costing less than a specified dollar amount; or
  - Amounts paid for property with an economic useful life of 12 months or less;
- The taxpayer treats the amount paid for the property as an expense on its AFS in accordance with its written accounting procedures; and
- The amount paid for the property does not exceed **\$5,000 per invoice** (or per item as substantiated by the invoice).



# Taxpayer's without AFS

- The taxpayer has at the beginning of the taxable year accounting procedures treating as an expense for non-tax purposes:
  - Amounts paid for property costing less than a specified dollar amount; or
  - Amounts paid for property with an economic useful life of 12 months or less;
- The taxpayer treats the amount paid for the property as an expense on its books and records in accordance with these accounting procedures; and; and
- The amount paid for the property does not exceed **\$500 per invoice** (or per item as substantiated by the invoice).



# Capitalization Policy

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- Not defined in the Final Regulations.
- A Capitalization Policy should have
  - Consistency and
  - An audited methodology for determining de minimis expenses.
- The greater the ambiguity, the greater chance of an examiner disallowing.
- No one size fits all, depends on your particular facts and circumstances.
- Please discuss with your advisor before year end.



## *De Minimis* for a group of entities

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- If the entity's financial results are reported on the AFS for a group of entities, then the AFS may be treated as the AFS of the taxpayer, and
- The written accounting procedures provided for the group and utilized for the group's AFS may be treated as the written accounting procedures of the taxpayer.



# Disclaimer

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*These seminar materials are intended to provide the seminar participants with guidance in tangible asset regulation matters. The materials do not constitute, and should not be treated as professional advice regarding the use of any particular tangible asset treatment or the consequences associated with any technique. Every effort has been made to assure the accuracy of these materials. Eide Bailly LLP and the author do not assume responsibility for any individual's reliance upon the written or oral information provided during the seminar. Seminar participants should independently verify all statements made before applying them to a particular fact situation, and should independently determine the impact of any particular tax planning technique before recommending the technique to a client or implementing it on the client's behalf.*



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# Improvements to Tangible Property

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## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Significant Elements in the Final Regs

- Reinforced that the “plan of rehabilitation” doctrine has been replaced with a 263A doctrine for capitalizing otherwise deductible items associated with improvements
- Clarified rules around removal costs under Sec. 165
- Provision of Small Taxpayer Safe Harbor for buildings
- Routine Maintenance Safe Harbor expanded to buildings
- Clarification of betterment standards
- Treatment of post casualty expenditures under the restoration standards modified
- Clarification and refinement of “major component or substantial structural part” standard
- Election to capitalize repair deductions in conformity with book method

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

Unit of property for betterment and restoration analysis:

Real Property	Personal Property	Condominiums and Cooperative	Network Assets
<ul style="list-style-type: none"> <li>▪ Building structure</li> <li>▪ Building systems:                             <ul style="list-style-type: none"> <li>▪ HVAC</li> <li>▪ Plumbing system</li> <li>▪ Electrical system</li> <li>▪ All escalators</li> <li>▪ All elevators</li> <li>▪ Fire protection</li> <li>▪ Security system</li> <li>▪ Gas distribution</li> <li>▪ Other systems based on IRS guidance</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ General property:                             <ul style="list-style-type: none"> <li>▪ Functional interdependence</li> <li>▪ Facts and circumstances</li> </ul> </li> <li>▪ Plant property:                             <ul style="list-style-type: none"> <li>▪ Functional interdependence</li> <li>▪ Discrete and major function</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ Generally the portion of the building owned and its structural components</li> <li>▪ Building structure owned</li> <li>▪ Building systems</li> </ul>	<ul style="list-style-type: none"> <li>▪ Facts and circumstances</li> <li>▪ Published guidance</li> </ul>

Improvements to Tangible Property

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

Improvements to property analysis:

Betterment	Restoration	Adaptation
<ul style="list-style-type: none"> <li>▪ Corrects a material condition or defect at acquisition or production</li> <li>▪ Material addition or expansion</li> <li>▪ Material increase in quality, capacity, productivity, or efficiency</li> </ul>	<ul style="list-style-type: none"> <li>▪ Replacement and recognition of a loss on disposal of a component</li> <li>▪ Recognition of gain/loss on sale of component</li> <li>▪ Basis adjustment as a result of a casualty loss</li> <li>▪ Return to former operating condition when no longer functioning</li> <li>▪ Rebuild like new condition after class life</li> <li>▪ Replacement of major component or substantial structural part</li> </ul>	<ul style="list-style-type: none"> <li>▪ Adapts the property to a use not consistent with the intended ordinary use when originally placed in service</li> </ul>

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

Reinforce that the “plan of rehabilitation” doctrine has been replaced with a 263A doctrine for capitalizing otherwise deductible items associated with improvements

- Costs that directly benefit the improvement
- Costs that are incurred by reason of the improvement

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Clarification to rules around removal costs under Section 165

- Previously in situation where the taxpayer replaced property, could only deduct removal costs when the entire unit of property was replaced
- Final regs now allow deduction of removal costs for partial disposals
- Example – Taxpayer removes columns and girders in a building to increase the load-bearing capacity to 50%. Replacement of columns and girders constitutes a betterment. Taxpayer elects to treat disposal of columns and girders as a partial disposition. Cost to remove the columns and girders may be deducted.

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Safe Harbor for Small Taxpayers with Eligible Building Property

- Taxpayer may elect to deduct all costs associated with improvements if total amount paid for repairs, maintenance, improvements, and “similar” activities does not exceed the lesser of:
  - 2% of unadjusted basis
  - \$10,000
  - Qualifying Taxpayer – gross receipts  $\leq$  \$10,000,000 (three-year annual average)
    - New taxpayer and short year rules
  - Eligible Building Property – unadjusted basis  $\leq$  \$1,000,000
    - Determined under Sec. 1012
    - Leased to taxpayer – undiscounted rent expected to be paid under the entire lease term (including renewals)

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Routine Maintenance Safe Harbor Expanded to Buildings

- Definition – Recurring activities that the taxpayer expects to perform as a result of the taxpayer’s use
- Taxpayer must reasonably expect to perform the activities more than once during the 10-year period starting on original placed in service date of the building/building system
- Expectation not “unreasonable” merely because activity was not performed more than once during a 10-year period
  - Factors: recurring nature, industry practice, manufacturers’ recommendations, taxpayer’s experience
- Example – Taxpayer reasonably expects to perform HVAC service every four years, including disassembly, cleaning, inspection, repair, replacement, reassembly, and testing

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Clarification of Betterment Standard

- Clarify that in the “materially increase productivity, efficiency, strength, quality, or output” standard, not all attributes apply to all types of assets
- Remove the “facts and circumstances” provision – preamble suggests it is implied
  - Final Regs Preamble – “IRS and Treasury recognize” financial statement treatment may not be controlling for tax purposes
- Draw distinction between *material* and *minor* amelioration of prior defect.
- Revised *Refresh* and *Remodel* examples

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Material increase in capacity/efficiency

Ex. 17:	25% increase in depth of channel = material increase in capacity
Ex. 20:	10% increase in energy efficiency of 2 out of 10 roof mounted HVAC units = no material increase in efficiency
Ex. 21:	50% reduction in energy and power costs from new insulation = material increase in efficiency

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Retail store refresh/remodel

<b>Ex. 6 (refresh):</b>	<b>No significant changes</b>
<b>Ex. 7 (limited improvement):</b>	Significantly different facts, clear improvement separate from refresh activities
<b>Ex. 8 (major remodel):</b>	Significantly different facts, clear improvement impacting most of store

Industry Issue Resolution project in process for retail industry

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Material addition

<b>Ex. 22:</b>	<b>Drive through service area added = material addition (physical expansion, extension, and addition of a major component)</b>
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## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Modified Treatment of Post Casualty Expenditures under the Restoration Standard

- Amounts capitalized because of casualty loss limited to adjusted basis in the loss property less any amounts required to be capitalized under any other provision in the restoration standard
- Preamble states that the purpose is to mitigate harsh results for taxpayers with valuable property and low adjusted basis

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Clarification of “Major Component” and “Substantial Structural Part”

Major component	Part or combination of parts that perform a discrete and critical function in the operation of the UOP
Substantial structural part	Part or combination of parts that comprises a large portion of the physical structure of the UOP

- Major component is considered replaced if a significant part of a major component is replaced
  - Examples suggest 30-40% range to constitute a significant part

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Clarification of “Major Component” and “Substantial Structural Part”

#### Restoration

- 1 chiller in HVAC system
- Entire sprinkler system
- All wiring in building
- All restroom fixtures
- 200 of 300 windows
- 100 of 300 windows (windows cover 90% of building)
- 40% of sq ft of flooring

#### Not a restoration

- 1 of 3 furnaces
- 3 of 10 roof HVAC units
- 30% of electrical wiring
- 8 of 20 sinks
- 100 of 300 windows (300 windows cover 25% of building surface area)
- 10% of sq ft of flooring
- 1 of 4 elevators

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Clarification of Adaptation to New and Different Use

#### New or different use:

- Manufacturing plant to showroom space
- Develop land used for manufacturing plant as residential housing
- Retail drug store converts area of pharmacy to walk-in medical clinic

#### Not a new or different use:

- 3 leased retail spaces into 1 leased retail space
- Preparing a building for sale
- Grocery store converts existing store space into sushi bar
- Hospital modifies emergency room to also provide outpatient surgery clinic

## §1.263(a)-3 Amounts Paid to Improve Tangible Property

### Election to capitalize repair deductions in conformity with book method

- Preamble states the provision is in response to the significant requests to reduce administrative burden.
- **Important Note:** This is a one way election. It only applies to amounts deductible for tax, but capitalized for book purposes. Taxpayer who makes the election would still have exposure for items improperly deducted as repairs and maintenance for tax purposes.

## Points to Consider – Costs to Improve Tangible Property

### Understand current method(s)

- Treatment of costs to repair or improve tangible property
- Who and how are those determinations made
- Detail that supports classification

### Consider criteria used in determining if an expenditure is an improvement

- UOP for buildings and equipment
- Aligning book and tax policies for repairs/improvements
- Administrative burden vs. Tax benefit
- Routine maintenance safe harbor for buildings and equipment

### Election to conform to book reporting

- Election made by treating filing statement in a timely filed tax return
- Election may be applied for tax years beginning on or after Jan.1, 2012



## Disposition of Tangible Property

## Dispositions of Tangible Property

- Temporary regulations used complicated rules to take partial dispositions through general asset accounts
- The proposed regulations under § 1.168(i)-8 include the election to dispose of structural components in a building and components of tangible personal property.
- A disposition includes:
  - Sale or exchange
  - Retirement
  - Physical abandonment
  - Destruction
  - Transfer to a supplies, scrap, or similar account
  - Retirement of a structural component of a building
  - Involuntary conversion
- Application of the rule applies to both tangible personal property and real property and is determined in the year of disposition.

## Points to Consider – Disposition of Tangible Property

- Understand current method(s)
  - Treatment of disposals of tangible property as it relates to components of property
  - Detail of replacement expenditures
- Consider taking a loss on a partial disposition
  - Improvement capitalized
  - Ability to determine net tax basis of component disposed
- Election to capitalize certain costs
  - Election made by treating items as a disposition in a timely filed tax return
  - Currently limited to apply these rules to tax years beginning on or after Jan.1, 2012

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# PROCEDURAL ISSUES

1. Does everyone need to file a Form 3115?
2. When should the Form 3115 be filed?
3. What level of detail should be included in Form 3115?
4. Additional guidance expected from the IRS and Treasury in the form of two new revenue procedures, which should be issued in November.