Conner Ash P.C.

CAPITALIZING VS. EXPENSING-
CHANGES REQUIRED IN 2014

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Presented by Helen Floros, CPA

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It applies to you

Q: Who does this repair reg apply to?

A: Any taxpayer with real and personal property. This includes nonprofits with unrelated business taxable income (UBTI).

Good news or bad?

This is generally **favorable news** for the taxpayer.

- It should reduce administrative burden and increase deductible expenses for repairs & maintenance.
- However, it will be more work for accountants providing information for the 2014 tax return.
- It will probably mean a Form 3115, Method Change in Accounting, to comply with the new Regulation.

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Today's Focus

- **BAR**
- **Unit of property (UOP)**
- **Major component**
- **De Minimis election**

T.D. 9636, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property-Final is 300+ pages of very complex "guidance" that includes various elections, accounting method changes, safe harbors, specific definitions including supplies and their various treatments.

- Today's talk is meant as an overview.
- Please consider contacting your account executive for help on how these new regulations relate to your situation.

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When?

FINAL REGULATIONS **MUST** BE APPLIED TO TAX YEARS BEGINNING ON OR AFTER 1/1/14.

THERE HAVE BEEN PROPOSED, WITHDRAWN, REPROPOSED AND TEMPORARY REGULATIONS SINCE 2006. AFTER 7 YEARS THEY ARE NOW FINAL.

- DURING THIS REGULATORY LIMBO THE IRS HAD NOT BEEN SCRUTINIZING R&M ACCOUNTS.
- NOW THAT THE REGS ARE FINAL, THE IRS CAN BE EXPECTED TO MONITOR COMPLIANCE.

THAT WAS THEN…

How did you determine when to capitalize before?

In practice a lot of taxpayers made their capitalization decision based on dollar amount. Example: It cost $10K to paint the office so the amount was capitalized <u>because it was a significant dollar amount and the expenditure was expected to benefit more than 1 year.</u>

Previously taxpayers relied on case law for guidance. It was subjective.

THIS IS NOW…

- Now the final repair regs will guide us as to when to capitalize costs to acquire, produce or improve property. This will affect all taxpayers owning or leasing business property. Examples: buildings, equipment, supplies.
- Now, generally, unless the amount is a **betterment, adaptation or restoration (BAR) to the unit of property or major component, the expenditure may be expensed for tax purposes.**

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A GUY WALKS IN A BAR

CAPITALIZE IF A:

- **B**ETTERMENT

- **A**DAPTATION

- **R**ESTORATION

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Betterment

- Must be an improvement from ORIGINAL condition, NOT as it is NOW. It may be expected to materially increase the size, productivity, efficiency, strength, quality or output of the original unit of property.

- EXAMPLES: Lunchroom remodel is not just fixing worn out floor and painting. It is an upgrade to installing a deluxe beverage bar, expensive wood floor and granite counter tops.
- Retail remodel involves cosmetic and layout changes to **refresh** the store. As it does not improve the original layout, increase efficiency or enlarge the space, this is not a betterment and should be expensed. If new market focus and this is not just a refresh, expenditures are for a betterment & should be capitalized.

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Adaptation

- Must convert the asset to a new or another use
- EXAMPLE: A packaging line fills 12 ounce bottles. It is reworked such that it can now fill 20 ounce bottles.

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Restoration

- Asset was deteriorated and restored to a “like new” condition or
- Replacement of part/s that comprise a major component or substantial structural part of the UOP.
- EXAMPLE: Old tractor was barely functioning. It received new parts and was overhauled such that it is functioning almost as well as a new tractor.

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NEW TERMS

- UNIT OF PROPERTY
- MAJOR COMPONENT
- DE MINIMIS ELECTIONS
- DEFINITION OF SUPPLIES

EVEN THOUGH YOUR COMPANY MAY HAVE USED THESE CONCEPTS, THE IRS HAS ONLY NOW DEFINED THESE TERMS SUCH THAT FOLLOWING THE CURRENT POLICY IN THE PAST WAS COINCIDENTAL. THUS, FOR MOST COMPANIES THEIR IMPLEMENTATION GOING FORWARD WILL REQUIRE A CHANGE IN ACCOUNTING METHOD.

UOP & MAJOR COMPONENT

- A UNIT OF PROPERTY CONSISTS OF A GROUP OF FUNCTIONALLY INTERDEPENDENT COMPONENTS. EXAMPLE: YOU CAN NOT HAVE AN OPERATING VEHICLE WITHOUT TIRES, AN ENGINE, ETC. A MAJOR COMPONENT IS A PART OF THE COMBINATION OF PARTS THAT PERFORMS A DISCRETE & CRITICAL FUNCTION IN THE OPERATION OF THE UNIT OF PROPERTY.

- EXCEPTION FOR BUILDINGS-CAN INCLUDE 9 UNITS OF PROPERTY EVEN THOUGH FUNCTIONALLY INTERDEPENDENT (BUILDING STRUCTURE AND 8 BUILDING COMPONENTS):

1. BUILDING AND STRUCTURAL COMPONENTS
2. ESCALATORS
3. ELEVATORS
4. PLUMBING
5. ELECTRICAL SYSTEMS
6. GAS DISTRIBUTION SYSTEM
7. HEATING, A/C AND VENTILATION
8. FIRE-PROTECTION & ALARM SYSTEMS
9. SECURITY SYSTEM

COMPONENTS

- Capitalization standards must be applied separately to building structure and systems.

- Q2: 1 of the 6 HVAC units needs to be replaced. Does this need to be capitalized?
- A2: If only 1 of 6 units needs to be replaced, then approximately 17% of the HVAC component of a building was replaced. Unless it is a material improvement (such as much more efficient) the new thinking is not too capitalize as it only replaces what was there. If it **merely repairs, replaces or refreshes**, it is not a betterment.

- Rule of thumb-If not more than 35% of the total number of units (not dollars), not “material”. If not material, it can be expensed.

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EXAMPLE OF CAPITALIZING

- HVAC system includes many components but one chiller unit. The chiller unit is replaced with a comparable unit. The chiller unit is a A MAJOR COMPONENT AND PERFORMS A DISCRETE AND CRITICAL FUNCTION IN THE OPERATION OF THE HVAC SYSTEM. Because the chiller was restored, the new chiller must be CAPITALIZED.

- Example 17, TD 9636, page 57739

Example-Replace 7 of 20 sinks for $4K

- UOP-building
- Building structural system-plumbing
- Building system replacement cost-$200K
- Major component performing discrete and critical function-sink
- Number of sinks/total=7/20=35% DEDUCTIBLE

See Example 18, TD 9636, page 57739

The Hard Questions

- Are you replacing a major component or substantial structural part?
- Must look at "facts and circumstances". If replacing large physical portion or part that performs critical function of the operation of the unit of property, answer may be yes. Facts and circumstances include <u>% of total unit of property</u>.

Deducting as Repair & Maintenance

- In determining "routine maintenance" , ask "is the item expected to occur at least 2x during the unit's class life? "
- Yes-Expense to R&M
- No-Ask if it is a betterment, adaptation or restoration
- Example: A nonresidential building has a class life of 39 years. It will probably be painted several more times than 2x in 39 years. Painting, resealing floors, replacing broken doors should probably be expensed. Unless it significantly improves, adapts the property to a new use or completely rehabs the property, consider expensing the expenditure.
- Example: An individual has 2 trucks, one for farming and one for her home health nurse job. She replaces all the tires (major component) only every 8 years on the farm truck but every year for the truck needed for home health job. She would capitalize the tires for the farm truck and expense the tires on the home health nurse truck.

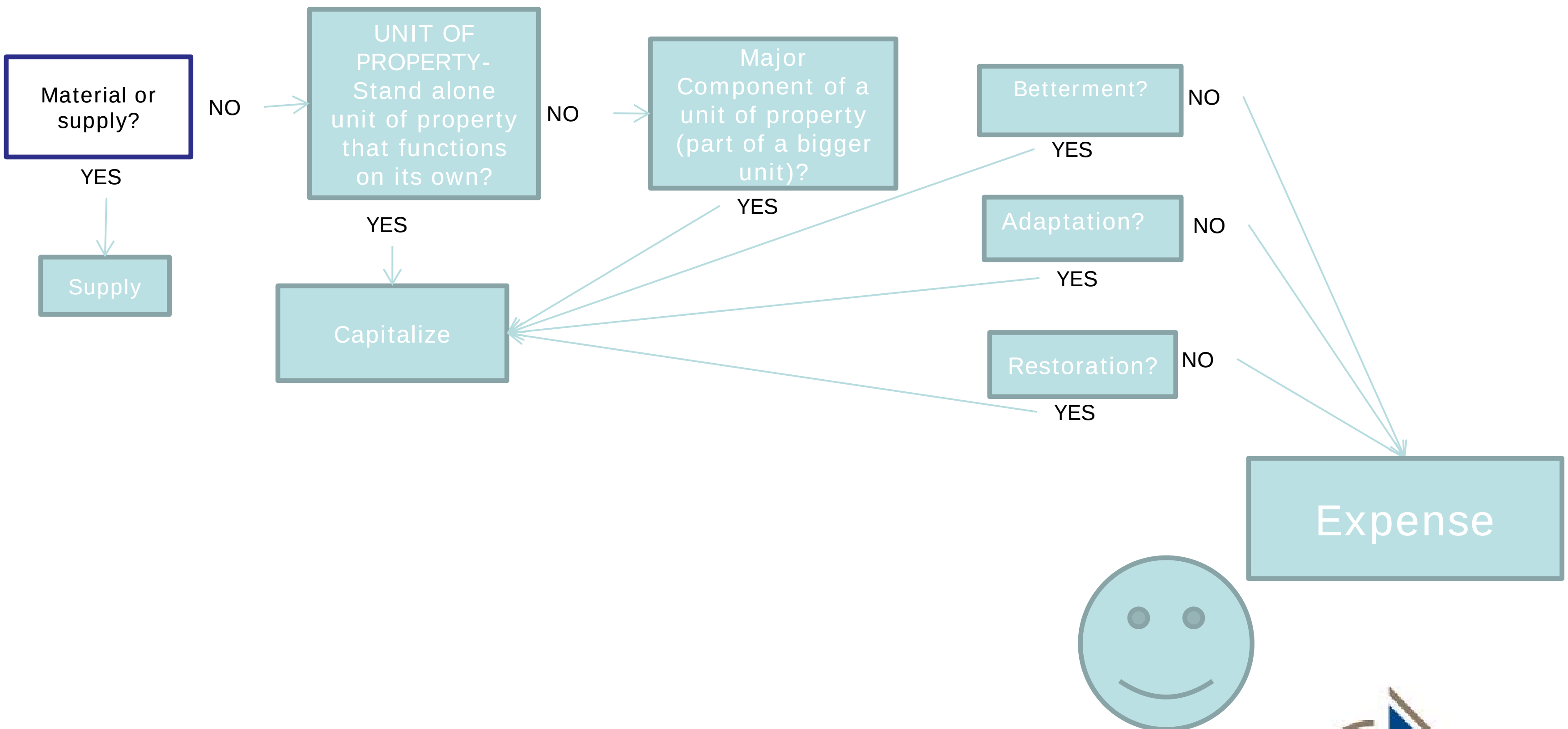
COST SEGREGATION STUDIES?

- Personal property often gets buried in the lump sum costs of a building purchase or construction project and ends up classified as real property and depreciated over a long tax life. A "cost seg" study can uncover such assets to take a shorter tax life for various categories of personal property and land improvements.
- The new thought is that the larger the "unit of property", the easier it is to justify expensing expenditures if they do not better, adapt or restore. Cost segs are still good to allocate construction costs to the building and 8 systems, all having 39 year lives.

Materials & Supplies

- New: Supplies are defined as costs that have a useful life of 12 months or less and costs less than $200 (formerly $100). These may be expensed.
- Final reg defines various categories of supplies:
  1. Rotable
  2. Incidental
  3. Nonincidental
  4. Temporary
  5. Standby emergency spare parts

CAPITALIZATION DECISION TREE



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De Minimis safe harbor

This election provides the ability to deduct under a specified dollar threshold:

$500 most taxpayers/$5,000-companies with AFS*. With this annual election the taxpayer is granted audit protection and the IRS will not look at amounts under $500. However, <u>this election states that for both book AND tax ALL amounts under $500 /$5,000 are expensed.</u>

*AFS-Applicable Financial Statements are either audited or those provided to a regulatory agency.

Taxpayer needs written capitalization policy starting the beginning of the year for the $5K threshold. A written policy is not necessary for the $500 level but is considered a “Best Practice.”

Example: Rather than tediously ask yourself if each piece of office equipment be capitalized if you have the $500 annual election in place, you may expense each item. You may want to consult your Conner Ash account exec about this first as it requires consistency with book treatment. For example, if you don’t believe your banker will give you a loan if you now show a book loss because of all the expensing of items under the de Minimis threshold, you may not want to elect the de Minimis election.

The dollar amount must be substantiated by the invoice.

What if…

Q1: What if my accounting policy is to expense anything under $1K? Can I do that for tax, as well as book?

A1: The De Minimis tax election for companies without AFS is $500. After that the expenditures can be reviewed on a facts and circumstances basis.

WHAT YOU SHOULD BE DOING NOW?

1. **Review your fixed asset register for items:**

- **Which are long gone and should be written off. Abandoned assets, generally those disposed with no proceeds, could lead to an ordinary loss adjustment. Under the old rules if you replaced a roof you had to keep depreciating the old roof AND start depreciating the new roof. Now is the time to deduct the old roof (allocating cost by any reasonable method) and any other partial disposals of a unit of property.**

- **Other potential tax write offs: previously capitalized improvements now considered deductible "repairs" or abandoned leasehold improvements or other property**

2. Consider recording counts of HVAC units, light fixtures, etc. when purchased.

3. Consider having a <u>written capitalization policy</u> in your company accounting manual for your accounting staff to follow. This is necessary for the $5K De Minimis election. Without a written policy your "policy" is what you have consistently applied over the years.

4. Aggregate costs relative to a unit of property. A car's cost includes sales tax and any fix up costs if it was not purchased in running condition.

5. If you elected a general asset account (GAA) in 2012 or 2013 consider revoking the election. This election is no longer favorable.

6. Consult with your Conner Ash account executive about

- Potential need for a Form 3115, Method Change in Accounting
- De Minimis Election
- Safe harbor for maintenance for buildings of small businesses

Questions/Discussion?

Contact Conner Ash with question

- Contact info-your account executive or me:

  Helen Floros

  hfloros@connerash.com

Consider sending an email question with lots of detail and I will get back to you by the end of the day.

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