

November 4, 2013

Dear Client:

I'm writing to let you know about an important development that will affect nearly every business, including yours. On Dec. 23, 2011, IRS issued temporary regs that provide guidance on whether businesses can deduct or must capitalize amounts that they pay to acquire, produce, or improve tangible property.

Effective date. Initially, the temporary regs were to have taken effect for tax years beginning in 2012. However, IRS has now changed its position and given taxpayers the option of applying the temporary regs to tax years beginning in 2012 and 2013.

IRS expects to issue final regs during 2013. The final regs will differ from the temporary regs, in part because of comments received from the public. IRS has said that the final regs may include simplifications and provide relief for small businesses.

The final regs are expected to apply to tax years beginning on or after Jan. 1, 2014, or, at the taxpayer's option, to tax years beginning on or after Jan. 1, 2012.

Overview of regs. The regs provide guidance in areas formerly covered by court decisions. In some cases, they simply codify the existing rules, while in other cases they break new ground.

The regs are lengthy and complex. The summary below is intended to give an overview of how the regs treat issues of deduction and capitalization. I would be happy to sit down with you to discuss the regs at length and see how they will affect your specific business situation.

Capitalization or deduction. Amounts paid to improve a unit of property must be capitalized. The regs create all-encompassing guidelines on what constitutes an improvement, namely an expenditure that better or restores a unit of property or adapts it to a new and different use.

The regs allow a current deduction for repairs and maintenance to property. Deductible repair and maintenance expenses are defined in a negative way-they are deductible if not otherwise required to be capitalized.

A current deduction is also allowed for amounts paid to produce and acquire materials and supplies that are consumed during the year. Materials and supplies are defined as including five specific categories of property used or consumed in the taxpayer's business operations.

For example, as under prior law, units of property with an economic useful life of no more than 12 months qualify as materials and supplies under this rule. Likewise, units of property that cost \$100 or less to acquire or produce qualify as materials and supplies.

Unit of property. One of the key issues in the temporary regs is the definition of the "unit of property" (UOP) that is being repaired or improved. The smaller the UOP, the more likely it is that costs incurred in connection with it will have to be capitalized.

For example, work on an engine of a vehicle is more likely to be classified as an expense that must be capitalized if the engine is classified a separate UOP. By contrast, if the UOP is the vehicle, the engine work has a better chance of passing muster as a repair.

In the past, taxpayers have increased their repair deductions by taking an expansive view of what is the UOP. The temporary regs will curtail that tendency by applying detailed rules to the issue. Different rules apply to buildings and to other property.

Buildings. When it comes to buildings, the regs generally treat each building and its structural components as one UOP-the "building." In addition, the regs list nine specified building systems that are treated as separate from the building structure. An improvement to the building is defined by its effect on those systems, rather than its effect on the building as a whole.

Thus, if a taxpayer restores a building structure, such as by replacing the entire roof, the expense is treated as an improvement to the single UOP consisting of the building. If the taxpayer makes an improvement to a building system, such as the heating, ventilation, and air conditioning (HVAC) system, that expense is also an improvement to the building UOP.

Property other than buildings. In general, for property other than buildings, a single UOP consists of all components that are functionally interdependent, such that one component can't be placed in service without the other components.

Say that a business buys a battery-powered golf cart for use by its foreman to get around a large warehouse. It buys the cart chassis from one vendor and the battery from another, and then assembles the two components. Here, the UOP is the cart, since the chassis can't be placed in service without the battery.

Routine maintenance safe harbor. The regs adopt a new safe harbor that many businesses will find useful. Under this rule, the cost of routine maintenance performed on a UOP that isn't a building or a structural component is currently deductible.

Routine maintenance refers to the recurring activities that a taxpayer expects to perform to keep a UOP in ordinarily efficient operating condition. Examples are inspection, cleaning, testing, and replacing the parts of the UOP with comparable replacement parts. The taxpayer must reasonably expect to perform the activities more than once during the class life (under the alternative depreciation rules) of the UOP.

Changes to depreciation regs. The temporary regs modify the existing regs on the depreciation of capital assets. Some, but not all, of the modifications are intended to coordinate depreciation rules with the other rules in the temporary regs discussed above. Topics addressed in the modifications include the tax treatment of dispositions of depreciable assets; the maintenance of general asset accounts, and other multiple asset accounts, for depreciable assets; and the depreciation of leasehold improvements.

Accounting method changes. A change to conform to the temporary regs is considered a change in accounting method, for which an accounting adjustment is required. IRS has issued procedures under which taxpayers can obtain automatic consent to the accounting method change.

Please give us a call if you have any questions. We would be pleased to assist you by discussing these important new regs in detail.

Sincerely,

A handwritten signature in black ink, appearing to read "Matt Hitt", with a stylized flourish extending to the right.

Matthew B. Hitt, CPA