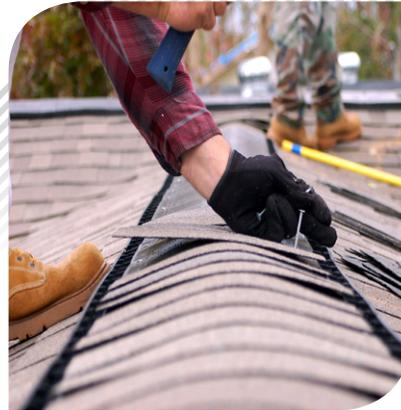


## THE FINAL TANGIBLE ASSET AND REPAIR REGULATIONS

# Favorable changes to materials and supplies, & de minimis safe harbors



On Sept. 13, 2013, the Treasury Department and the IRS (hereinafter called the Government), released the much anticipated final (and proposed) tangible asset and repair regulations (the final regulations). The majority of the regulations were issued in final form.<sup>1</sup> However, as expected, regulations surrounding dispositions of tangible property were issued in proposed form,<sup>2</sup> but also as reliance guidance. The Government has not yet released updated transitional guidance (modifying or superseding Rev. Procs. 2012-19 and 2012-20, which provide the automatic method change procedures for taxpayers to early adopt provisions of the temporary regulations). It is expected that such guidance will be issued within the next few weeks.

As discussed in depth below, the final regulations governing materials and supplies and de minimis amounts are very taxpayer-favorable. Accordingly, taxpayers should assess the earliest tax year for which they are eligible to apply the new guidance and take steps now to ensure their ability to reap the benefits.

### Background

On Dec. 23, 2011, the government released temporary<sup>3</sup> and proposed<sup>4</sup> regulations (the temporary regulations) governing the deduction and capitalization of cost incurred to acquire, maintain or improve tangible property, and also providing new rules regarding materials and supplies and dispositions of Modified Accelerated Cost Recovery System (MACRS) property. While the temporary regulations were originally issued as effective for tax years beginning on or after Jan. 1, 2012, the government in late 2012 delayed the effective date to tax years beginning on or after Jan. 1, 2014, and identified areas likely to be favorably changed by the final regulations to be issued during 2013. The final regulations were recently released and are generally effective for tax years beginning on or after Jan. 1, 2014, or, where applicable, to amounts paid or incurred on or after Jan. 1, 2014. As communicated in prior articles, taxpayers have the option of early adopting portions of the temporary or final regulations for taxable years beginning on or after Jan. 1, 2012. In addition, the final regulations provide very favorable transition rules for specified annual elections.

<sup>1</sup> See TD 9636.

<sup>2</sup> See REG-110732-13.

<sup>3</sup> See TD 9564.

<sup>4</sup> See REG-168745-03.

## Overview

The final regulations provide the framework for determining the deductibility versus capitalization of costs incurred for materials and supplies, repairs and maintenance, and other tangible asset costs. Specifically, the final regulations provide rules in the following five general areas:

- 1) Materials and supplies
- 2) Capital expenditures in general (including the de minimis safe harbor)
- 3) Costs to acquire or produce tangible property
- 4) Costs to improve tangible property
- 5) Dispositions of MACRS property (including components thereof) and general asset accounts (GAAs)

Throughout each of the areas above, the final regulations retain many of the provisions of the temporary regulations while also favorably clarifying, modifying and simplifying some of the provisions (e.g., a simplified de minimis safe harbor election). The final regulations also provide small business relief (i.e., a safe harbor election for improvements to building property) and re-proposed new rules (i.e., for dispositions). This is the first of a series of alerts focusing on the final regulations and changes made to the temporary regulations. Following is a discussion of the final rules governing materials and supplies and the de minimis safe harbors.

## Materials and Supplies

The final regulations expand the definition of the term “materials and supplies” to include items costing \$200 or less (increased from \$100 or less and retaining the government’s authority to change the threshold through published guidance), as well as emergency spare parts (e.g., a bearing seal for a plant generator, a utility’s turbine blade assembly, etc.).<sup>5</sup> As a result, materials and supplies now include tangible property that is used or consumed in the taxpayer’s operations, that is not inventory held for sale, and that:

- 1) Is a component acquired to maintain, repair, or improve a unit of tangible property (UOP) owned, leased, or serviced by the taxpayer and that is not acquired as part of any single UOP, including rotatable and temporary spare parts (rotables) and standby emergency spare parts;
- 2) Consists of fuel, lubricants, water, and similar items reasonably expected to be consumed in 12 months or less, beginning when first used in the taxpayer’s operations (e.g., jet fuel);
- 3) Is a UOP that has an economic useful life of 12 months or less, beginning when first used or consumed in the taxpayer’s operations;
- 4) Is a UOP that has an acquisition cost or production cost of \$ 200 or less; or
- 5) Is identified in published guidance as materials and supplies.<sup>6</sup>

Under the final regulations, taxpayers may make an annual election to capitalize and depreciate rotables or standby emergency spare parts.<sup>7</sup> However, other types of materials and supplies are not eligible for such an election. This represents a divergence from

the temporary regulations that provided taxpayers with an annual election to capitalize any material and supply, regardless of whether or not the material or supply was a rotatable. In addition, the final regulations clarify that once made, a taxpayer may only revoke its election to capitalize and depreciate eligible materials and supplies via a letter ruling request (i.e., not by filing a method change request).<sup>8</sup> The ability to deduct materials and supplies under the de minimis safe harbor is discussed in the de minimis safe harbor section below.<sup>9</sup>

While the final regulations continue to provide that the default method of accounting for rotables is to deduct upon disposal, the final regulations modify the optional method of accounting for rotables provided by the temporary regulations.<sup>10</sup> Specifically, while under the temporary regulations the optional method, if elected, had to be used for all of a taxpayer’s rotables, under the final regulations (if elected) the optional method must only be used for all of the pools of rotables used in the same trade or business for which the optional method is used for the taxpayer’s books and records. However, if a taxpayer elects to use the optional method for any pool of rotables for which it does not use the optional method for book purposes, the taxpayer must use the optional method for all of its pools of rotables in that trade or business.

It is important to note that even if a material and supply is deductible under Reg. section 1.162-3, it could still be subject to capitalization under either section 263A as an inventoriable cost or Reg. section 1.263(a)-3 as an improvement.

5. Reg. section 1.162-3(c)(3) defines standby emergency spare parts as materials and supplies that are: “(i) acquired when particular machinery or equipment is acquired (or later acquired and set aside for use in particular machinery or equipment), (ii) set aside for use as replacements in order to avoid substantial operational time loss caused by emergencies due to particular machinery or equipment failure, (iii) located at or near the site of the installed related machinery or equipment so as to be readily available when needed, (iv) directly related to the particular machinery or piece of equipment they serve, (v) normally expensive, (vi) only available on special order and not readily available from a vendor or manufacturer, (vii) not subject to normal periodic replacement, (viii) not interchangeable in other machines or equipment, (ix) not acquired in quantity (generally only one is on hand for each piece of machinery or equipment), and (x) not repaired and reused.”

6. Reg. section 1.162-3(c)(1).

7. Reg. section 1.162-3(d).

8. Taxpayers that failed to make the election to capitalize rotables or standby emergency spare parts (as provided in the final regulations) on their timely filed 2012 or 2013 tax returns may still make the election by filing an amended return within 180 days of the extended due date. This transition rule applies regardless of whether the taxpayer extended its return.

9. See, generally, Reg. sections 1.162-3(f) and 1.263(a)-1(f).

10. See Reg. section 1.162-3(e).

## Summary of changes to rules governing materials and supplies

Definitions	
<ul style="list-style-type: none"> <li>Component acquired to maintain, repair or improve UOP, including rotables</li> </ul>	<ul style="list-style-type: none"> <li>Same, with addition of standby emergency spare parts</li> </ul>
<ul style="list-style-type: none"> <li>Fuel, lubricants, water, etc. reasonably expected to be consumed in 12 months or less, beginning when first used in taxpayer's operations</li> </ul>	<ul style="list-style-type: none"> <li>Same</li> </ul>
<ul style="list-style-type: none"> <li>UOP with economic useful life of 12 months or less, beginning when first used or consumed in taxpayer's operations</li> </ul>	<ul style="list-style-type: none"> <li>Same</li> </ul>
<ul style="list-style-type: none"> <li>UOP with acquisition / production cost of \$100 or less</li> </ul>	<ul style="list-style-type: none"> <li>Limit increased to \$200 or less</li> </ul>
<ul style="list-style-type: none"> <li>Identified in published guidance as materials and supplies</li> </ul>	<ul style="list-style-type: none"> <li>Same</li> </ul>
Methods	
<ul style="list-style-type: none"> <li>Incidental deduct when purchased</li> </ul>	<ul style="list-style-type: none"> <li>Same</li> </ul>
<ul style="list-style-type: none"> <li>Non-incident deduct when used or consumed</li> </ul>	<ul style="list-style-type: none"> <li>Same</li> </ul>
<ul style="list-style-type: none"> <li>Election to capitalize and depreciate any material and supply</li> </ul>	<ul style="list-style-type: none"> <li>Restricted to rotables and standby emergency spare parts (not eligible for de minimis)</li> </ul>
<ul style="list-style-type: none"> <li>Election to apply de minimis rule to any material and supply</li> </ul>	<ul style="list-style-type: none"> <li>If de minimis safe harbor elected, applies to all eligible materials and supplies except as otherwise provided</li> </ul>
<ul style="list-style-type: none"> <li>Rotables</li> </ul>	<ul style="list-style-type: none"> <li>Rotables</li> </ul>
<ul style="list-style-type: none"> <li>Deduct upon disposal, or</li> </ul>	<ul style="list-style-type: none"> <li>Same</li> </ul>
<ul style="list-style-type: none"> <li>Use optional method for all rotables</li> </ul>	<ul style="list-style-type: none"> <li>Optional method only for pools of rotables used in same business if also book method               <ul style="list-style-type: none"> <li>If not book method, must use for all pools of rotables in business for tax purposes</li> <li>Not eligible for de minimis</li> </ul> </li> </ul>

## De minimis safe harbors

The final regulations favorably remove the ceiling limitation from the de minimis rule provided in the temporary regulations and replace it with a new safe harbor that is determined at the invoice or item level based on the taxpayer's capitalization policy utilized for book purposes.<sup>11</sup> Under the new de minimis safe harbor, a taxpayer may deduct amounts paid for property of up to \$5,000<sup>12</sup> per invoice or item if the taxpayer:

1. Has an applicable financial statement (AFS);
2. Has, at the beginning of the taxable year, written accounting procedures for expensing amounts paid for property either costing less than a certain dollar amount or with an economic useful life of 12 months or less; and
3. Treats such amounts as expenses on its AFS in accordance with such written procedures<sup>13</sup>

The final regulations use the same definition of an AFS as provided by the temporary regulations.

Specifically, for purposes of the de minimis safe harbor, the definition of an AFS was not expanded to include reviewed financial statements, but rather only includes:

1. A financial statement required to be filed with the Securities and Exchange Commission (SEC) (e.g., Form 10-K);
2. A certified audited financial statement that is accompanied by the report of an independent CPA and used for credit purposes, reporting to owners, or any other substantial non-tax purpose; or
3. A financial statement required to be provided to the federal or state government or any federal or state agencies (other than the SEC or IRS).<sup>14</sup>

If the taxpayer's financial results are reported on the AFS for a group of entities (even if the taxpayer is not included in the consolidated group for federal income tax purposes), the group's AFS may be treated as the taxpayer's AFS.<sup>15</sup> In addition, 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.

While not expanding the definition of an AFS, the final regulations do favorably provide a de minimis rule for taxpayers without an AFS. Specifically, a taxpayer without an AFS may deduct amounts paid of up to \$500,<sup>16</sup> per invoice or item, or for property with an economic useful life of 12 months or less if the taxpayer:

1. Has, at the beginning of the taxable year, written accounting procedures for expensing amounts paid for property either costing less than a certain dollar amount or with an economic useful life of 12 months or less, and
2. Treats such amounts as expenses on its books and records in accordance with such written procedures.<sup>17</sup>

If the cost of an invoice or item (as applicable) exceeds the applicable threshold, no amount may be deducted under the de minimis safe harbor. In applying either de minimis safe harbor, a taxpayer must include the additional costs of acquiring property (e.g., delivery fees, installation costs, etc.) that are included on the same invoice as the property.<sup>18</sup> However, a taxpayer electing the safe harbor does not have to include additional costs of acquiring or producing the property if such costs are not included on the same invoice as the property.

In situations where the invoice includes amounts paid for multiple items of tangible property and the invoice includes

additional costs related to the multiple properties, the taxpayer must allocate the additional costs to each property using a reasonable method (e.g., specific identification, pro rata allocation, or a weighted average method based on each property's relative cost).

As previously noted, a taxpayer must have a written accounting procedure in place at the beginning of the tax year in order to be eligible to use either de minimis safe harbor. Accordingly, if a taxpayer does not currently have written accounting procedures in place, it may not elect to use either de minimis safe harbor method until the tax year in which such procedures are in place and followed as of the beginning of such year (i.e., retroactive application of a capitalization policy is not permitted). In addition, a change in written accounting procedures does not, in and of itself, constitute a change in method of accounting. Regardless of whether a taxpayer has or does not have an AFS, taxpayers and IRS agents can agree on amounts in excess of the limitations, but if a taxpayer seeks a deduction for amounts in excess of the safe harbor amount, the taxpayer has the burden of showing such treatment clearly reflects income.

Neither of the de minimis safe harbors applies to amounts paid for (1) inventory property (or items to be included in inventory property), (2) land, (3) rotables and standby emergency spare parts that the taxpayer elects to capitalize and depreciate, and (4) rotables for which the taxpayer elects the optional method.<sup>19</sup>

<sup>11</sup> See Reg. section 1.263(a)-1(f).

<sup>12</sup> The final regulations provide Treasury and the IRS with the authority to change the safe harbor amount through published guidance.

<sup>13</sup> Reg. section 1.263(a)-1(f)(1)(i).

<sup>14</sup> Reg. section 1.263(a)-1(f)(4).

<sup>15</sup> Reg. section 1.263(a)-1(f)(3)(vi).

<sup>16</sup> The final regulations provide Treasury and the IRS with the authority to change the safe harbor amount through published guidance.

<sup>17</sup> Reg. section 1.263(a)-1(f)(ii).

<sup>18</sup> Reg. section 1.263(a)-1(f)(3)(i).

<sup>19</sup> Reg. section 1.263(a)-1(f)(2).

A taxpayer elects the de minimis safe harbor annually by including a statement on its timely filed original tax return for the year of election with the information below:

**Section 1.263(a)-1(f) de minimis safe harbor election**

- Taxpayer’s name
- Taxpayer’s address
- Taxpayer’s identification number
- The taxpayer is hereby making the de minimis safe harbor election under section 1.263(a)-1(f).<sup>20</sup>

In the case of a consolidated group, the common parent should make the election, and the statement above must include the names and taxpayer identification numbers of each member for which the election is being made. In the case of an S corporation or a partnership, the entity makes the election (not the shareholders or partners).

If a taxpayer elects the safe harbor, it must apply the safe harbor to all amounts paid in the year that meet the requirements of the safe harbor, including all materials and supplies that meet the requirements (except for rotables or standby emergency spare parts subject to the election to capitalize, or rotables subject to the optional method of accounting for such parts).<sup>21</sup> Once made, the election is generally irrevocable and may not be changed through the filing of an application for change in accounting method.

Eligible de minimis amounts are generally deductible in the year incurred (i.e., they are not treated as materials and supplies, acquisition costs or improvement costs).<sup>22</sup> However, such amounts may still be subject to capitalization under 263A.<sup>23</sup>

**Summary of changes to the de minimis rule**

Issue	Temporary regulations	Final regulations
<b>DE MINIMIS AMOUNTS</b>		
Taxpayers with an AFS	<ul style="list-style-type: none"> <li>• Follow book capitalization policy up to ceiling if in effect and followed in AFS since beginning of tax year</li> <li>• Aggregate de minimis deduction limited to greater of:               <ul style="list-style-type: none"> <li>- 0.1 percent of tax gross receipts, or</li> <li>- 2 percent of total AFS depreciation and amortization</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Same, but no ceiling and only up to \$5,000 per item or invoice, as applicable</li> <li>- Not applicable</li> </ul>
Taxpayers without an AFS	<ul style="list-style-type: none"> <li>• Not applicable</li> </ul>	<ul style="list-style-type: none"> <li>• Follow book capitalization policy up to \$500 per item or invoice, as applicable, if in effect and followed in books and records since beginning of tax year</li> </ul>
Ineligible amounts	<ul style="list-style-type: none"> <li>• Inventory property (or items to be included in inventory property)</li> <li>• Land</li> </ul>	<ul style="list-style-type: none"> <li>• Expanded to also exclude:               <ul style="list-style-type: none"> <li>- Rotables / standby emergency spare parts capitalized and depreciated</li> <li>- Rotables accounted for under optional method</li> </ul> </li> </ul>
Election statement	<ul style="list-style-type: none"> <li>• Not applicable</li> </ul>	<ul style="list-style-type: none"> <li>• Required annually with timely filed return</li> </ul>

<sup>20</sup> Reg. section 1.263(a)-1(f)(5).  
<sup>21</sup> Reg. section 1.263(a)-1(f)(3)(ii).  
<sup>22</sup> Reg. section 1.263(a)-1(f)(3)(iv).  
<sup>23</sup> Reg. section 1.263(a)-1(f)(3)(v).

## Insights

The final regulations governing materials and supplies and de minimis amounts are very taxpayer-favorable. The increase in the limit from \$100 to \$200 for treating one type of item as a material and supply will hopefully allow for the deductibility of more common office supplies (e.g., coffee makers, calculators, etc.). Similarly, the removal of the ceiling from the de minimis rule provided in the temporary regulations and the provision of a de minimis rule for taxpayers without an AFS are welcome news for taxpayers of all sizes. Taxpayers that currently do not have written capitalization policies but want to take advantage of the de minimis safe harbor should take steps now to ensure the appropriate accounting procedures and policies are in place by the beginning of their next tax year. While the de minimis safe harbor generally must be annually elected on a timely filed tax return, taxpayers with existing, written capitalization policies that have not been following their book treatment for tax purposes have a limited-time opportunity to amend their returns for tax years beginning on or after Jan. 1, 2012, and ending on or before Sept. 19, 2013, to make de minimis safe harbor elections under the final regulations.<sup>24</sup> Going forward, in order to deduct eligible de minimis amounts, taxpayers will want to ensure inclusion of the required election statement in each year's tax return.

<sup>24</sup> See Reg. section 1.263(a)-1(h)(2)(ii), providing eligible taxpayers with the ability to make late de minimis safe harbor elections by filing an amended return within 180 days of the extended due date for the applicable tax year, regardless of whether the taxpayer extended such return.

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