

February 2015

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## **Tangible Property Regulations and Form 3115**

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The IRS recently issued final regulations, effective January 1, 2014, on the treatment of costs to acquire, produce or improve tangible property, to be applied to 2014 tax returns in determining if taxpayers can deduct costs immediately as repairs and maintenance, or must capitalize and recover the costs over the applicable depreciation period.

Note: The IRS received much criticism for requiring all taxpayers to undergo this type of comprehensive review in order to adopt the regulations, and responded with significant relief (Revenue Procedure 2015-20) for “small business taxpayers” (less than \$10 million in assets on the first day of the 2014 tax year, or average annual gross receipts of less than \$10 million over the three preceding tax years). This relief allows a small business taxpayer to adopt all or most parts of the repair regulations without filing a Form 3115.

If you are a qualifying taxpayer you may not necessarily want to exercise this option though. Firstly, if you take advantage of the filing relief, you may not make a “late partial disposition election.” This election is a one-time opportunity available only in 2014 to treat prior-year retirements of structural components of buildings (such as a replaced roof) as a disposition that generates a retirement loss deduction. If you previously retired a structural component, you are likely still depreciating the cost allocable to the component. The partial disposition election allows you to claim a loss for the remaining undepreciated cost in 2014.

Secondly, if you choose to adopt the repair regulations without filing Form 3115, no deduction may be claimed in 2014 for amounts that you capitalized prior to 2014 but which are deductible under the final repair regulations. You must continue to capitalize and depreciate those amounts. This consideration, however, is offset by the fact that if a review of your prior expenditures reveals amounts that were claimed as repair deductions and those amounts are required to be capitalized under the repair regulations you must include the prior deductions in income in 2014.

It should also be pointed out that if you are selected for audit in some future year, the IRS has the authority to change the treatment of your prior expenditures to follow the treatment required by the final repair regulations even though you chose the small business taxpayer relief.

For those that do not qualify for the relief provisions - if any expenditures that were capitalized and depreciated in prior years should have been expensed under the standards of the repair regulations, it is necessary to file an accounting method change on Form 3115 to stop depreciating the capitalized amounts and claim a deduction in the amount that should have been expensed (reduced by the depreciation already claimed in past years). Conversely, if any amounts that were expensed in a prior year should have been

capitalized under the standards of the final regulations, the expensed amounts (less depreciation that should have been claimed) are reported as income. Depending upon your particular situation, the net effect of compliance may be an additional deduction amount for 2014 or an additional income amount. Often (but not always) it turns out that the adjustment is favorable.

The IRS has indicated that business taxpayers who do not file Form 3115 with their 2014 tax return may be targeted for audit. Thus, compliance with these regulations is critical. It will require significant time and effort, despite several taxpayer-friendly changes. Every business, especially those with significant fixed assets, should develop an understanding of the regulations and their requirements.

The regulations will provide simplification and reduce controversy to the extent they allow taxpayers to follow their financial accounting (book) policies for certain expenditures. For example, de minimis safe harbor rules provide a \$500 per item safe harbor deduction for taxpayers that have a policy in effect at the beginning of the tax year to deduct items within the safe harbor deduction limit. The \$500 per item limit is increased to \$5,000 if you have an audited financial statement.

Other significant provisions in the final regulations relate to the following:

**Materials and supplies.** The threshold for deducting materials and supplies is increased from \$100 to \$200. Materials and supplies include many items that are expected to be consumed in 12 months or less, or that have an economically useful life of 12 months or less.

**Unit of property.** The final regulations retain controversial unit of property rules that apply the rules for real property to eight separate building systems, as well as to the overall structure. The IRS expects taxpayers with a building to submit a Form 3115 that defines the unit of property for the building in accordance with the final regulations. This filing does not increase or decrease your tax liability.

**Routine maintenance.** A routine maintenance safe harbor is expanded to include real property in addition to other property such as machinery. The routine maintenance safe harbor ensures the current deductibility of certain recurring maintenance. A taxpayer, however, must file Form 3115 to apply this provision to past and future expenditures.

**Capitalization election.** The final regulations allow taxpayers to capitalize repair and maintenance costs if they are capitalized for financial (book) accounting purposes. This is a significant simplification over earlier proposed guidance. It is an annual election and does not require filing Form 3115.

As you can see, the repair regulations are extensive and complex. Determining whether particular costs should be deducted or capitalized will be challenging. The decision to opt out of filing Form 3115 under the small business taxpayer relief needs to be made on a case-by-case basis by weighing the cost and inconvenience of the filing requirement against the value of any potential benefits. We are ready to help you digest and understand the regulations, determine what accounting and record-keeping policies you may need, and make appropriate elections to comply with the regulations. Please contact us so that we can help you address these rules.