



**KNAV is a firm
of International
Accountants, Tax and
Business Advisors.**

Presence in |

INDIA
USA
UK
FRANCE
NETHERLANDS
SWITZERLAND
CANADA

E: admin@knavcpa.com

W: www.knavcpa.com

Accounting for Income Tax Implications of the Tangible Property Regs.

The IRS issued final regulations under Secs. 162 and 263 (T.D. 9636) that provide guidance on amounts paid to acquire, produce, or improve tangible property. The final regulations further clarify the capitalization and expensing of amounts paid to acquire, maintain, improve, or replace tangible property, which will affect both taxable income and accounting for income taxes. Differences in tax treatment with respect to an entity's accounting policies versus the final regulations can change the balance of an entity's deferred taxes and potentially the recognition of a liability under Accounting Standards Codification (ASC) Subtopic 740-10.

Pursuant to Sec. 162(a), a deduction is allowed for all ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. These include costs of repairs and maintenance incurred in carrying on a trade or business. Under Sec. 263(a), amounts paid for permanent improvements or betterments, adaptation, or restorations made to any property must be capitalized. Determining whether to capitalize or deduct is based on the taxpayer's facts and circumstances and is subjective. The final regulations clarify and provide guidance on the criteria for deducting or capitalizing expenditures related to tangible property.

The final regulations, although effective Jan. 1, 2014, can be applied retroactively to tax years beginning on or after Jan. 1, 2012 (Rev. Proc. 2014-16). Any change implemented by taxpayers to comply with the final tangible property regulations may result in a change in method of accounting, thus generally requiring filing Form 3115, Application for Change in Accounting Method, with a Sec. 481(a) adjustment unless the taxpayer qualifies for the small business taxpayer exception found in Rev. Proc. 2015-20. Rev. Proc. 2015-20 allows small business taxpayers to make certain accounting method changes under the tangible property regulations without

filing Form 3115 in their first tax year beginning on or after Jan. 1, 2014, the effective date of the repair regulations.

Under the revenue procedure, small businesses can also make certain accounting method changes on a cut off basis, that is, with a Sec. 481(a) adjustment that only takes into account only amounts paid or incurred, and dispositions, in tax years after Jan. 1, 2014. For these purposes, the revenue procedure defines a small business as one with total assets of less than \$10 million on the first day of the tax year for which the accounting method change is effective or average annual gross receipts of \$10 million or less for the prior three tax years.

Further, various elections must be considered by taxpayers as discussed below and in Rev. Proc. 2014-16.

Key Provisions Under the Final Tangible Property Regulations

- **De minimis expensing safe harbor:** This provision allows taxpayers, if certain conditions are met, to expense for book and tax purposes all amounts paid for property below a specified dollar amount for the acquisition of tangible property. The maximum dollar amounts paid for property that can be expensed under the safe harbor are \$5,000 and \$500 per invoice or per item, respectively, for taxpayers with an applicable financial statement. See Regs. Sec. 1.162-3(c)(1)(iv) for the applicable dollar threshold for materials and supplies.
- **Materials, supplies, and spare parts:** The final regulations define materials and supplies to include property that has an acquisition or production cost of \$200 or less. The final regulations also clarify the definition of rotatable and temporary spare parts (Regs. Sec. 1.1623(c)(2)) and provide three ways to account for such items (Regs. Secs. 1.162-3(d), (e), and (f)).
- **Routine-maintenance safe harbor for buildings:** The final regulations expand the safe harbor to building property and allow a taxpayer to apply the routine-maintenance safe harbor to recurring activities to keep the unit of property in its ordinarily efficient operating condition (Regs. Sec. 1.263(a)-3(i)(1)(i)).
- **Capitalized repair and maintenance costs:** This provision allows a taxpayer to elect to capitalize certain repair and maintenance costs if those costs are also capitalized on the taxpayer's books and records (Regs. Sec. 1.263(a)-3(n)).

- Small taxpayer safe harbor for eligible building property: This safe harbor provides small taxpayers with an irrevocable annual election to simplify compliance with the "repair" and "improvement" rules for eligible building property (Regs. Sec. 1.263(a)-3(h)).
- Repair vs. improvement costs: The final regulations further clarify criteria for betterment versus restoration of tangible property.

ASC 740 Considerations

The final regulations will require taxpayers to make various elections or make changes in tax accounting methods. Generally, taxpayers required to file Form 3115 to make a method change will be required to make either a catch-up or modified cut off Sec. 481(a) adjustment. If an amount previously deducted is required to be capitalized, or vice versa, under the final regulations, a Sec. 481(a) adjustment is required unless the taxpayer is a small business taxpayer as defined in Rev. Proc. 2015-20 and qualifies to make the change prospectively.

An accounting method change generally results in a cumulative adjustment (a Sec. 481(a) adjustment) calculated as of the beginning of the tax year in which the change occurs. The cumulative adjustment captures the difference between the deductions allowable under the final regulations and those claimed on the originally filed returns. (This calculation is required even if the statute of limitation for the prior tax year(s) is closed.)

Under ASC Topic 740, Income Taxes, the effects of new legislation under the final tangible property regulations shall be recognized in an entity's financial statements at the date of enactment (ASC Paragraph 740-1025-47) and included in tax expense attributable to continuing operations (ASC Paragraph 740-10-45-15). Generally, the tax impact on deferred income taxes is recognized when Form 3115 is filed (ASC Paragraph 740-10-35-4); however, consideration should be given to the timing of recognition in the financial statements, as views on inclusion of accounting method changes can vary. Refer to Rev. Proc. 2014-16 and Rev. Proc. 2015-20 (which contains the small business taxpayer exception) for the principal guidance on when a taxpayer should file Form 3115. A change in tax law may also require the revaluation of a valuation allowance (ASC Paragraph 740-10-35-4).

Current provision

An entity's current taxable income computation may be affected. For example, filing Form 3115 is required under the optional accounting method for rotatable and temporary spare parts under Regs. Sec. 1.162-3(e) for taxpayers that do not qualify for the small business taxpayer exception in Rev. Proc. 2015-20. Therefore,

computation of the Sec. 481(a) adjustment under this rule will affect the entity's current tax provision.

Effective tax rate

Temporary items will generally have no impact on the effective tax rate. However, in certain instances, filing Form 3115 may indirectly affect the effective tax rate through its impact on other items in the tax return. Changes in permanent book-to-tax differences, as a result of adopting the final tangible property regulations, may affect the effective tax rate. For example, a change in taxable income due to the de minimis safe-harbor election will affect taxable income and consequently affect the computation of a Sec. 199 deduction. Pursuant to ASC Topic 740, the effect of a change in tax law, as discussed in the examples above, on taxes currently payable or refundable for the current year is reflected in the computation of the annual effective tax rate (ASC Paragraph 740270-25-5). Further, a change in tax law may require the revaluation of an entity's valuation allowance, which will affect the annual effective tax rate.

Uncertain tax positions

Generally, an uncertain tax position (UTP) relates solely to a position taken on a tax return that is not believed to meet the more-likely-than-not standard (ASC Paragraph 740-10-25-6). However, conformity between a tax return and financial statements may be required under certain provisions, such as the de minimis safe-harbor election. Recognition of a UTP would be appropriate if an entity did not correctly conform to the final regulations. A UTP could further arise if, for example, the de minimis safe-harbor election results in a material misstatement of the financial statements. Any unrecognized tax benefit should be analysed for interest and penalty considerations. Any underpayment interest should be recognized as of the first period in which the interest would begin to accrue (ASC Paragraph 740-10-25-56).

The final tangible property regulations may have a host of implications for an entity's accounting for its income taxes. An entity must carefully consider the impact of the final regulations for purposes of compliance with tax regulations as well as accounting for income taxes under ASC Topic 740.

Source: Reproduction - AICPA Tax Advisor

Disclaimer: These materials and the information ('this information') contained herein are provided by KNAV and are intended to provide general information on a particular subject or subjects and are not an exhaustive treatment of such subject(s).

This information is not intended to constitute accounting, tax, legal, investment, consulting, or other professional advice or services and should not be relied upon as the sole basis for any decision which may affect you or your business. No reader should act on the basis of any information contained in this publication without considering and, if necessary, taking appropriate advice upon their own particular circumstances. None of KNAV, its member firms, or its and their respective affiliates shall be responsible for any loss and any special, indirect, incidental, consequential, or punitive damages or any other damages whatsoever whether in an action of contract, statute, tort (including, without limitation, negligence), or otherwise, sustained by any person who relies on this information. If any of the foregoing is not fully enforceable for any reason, the remainder shall nonetheless continue to apply.