IMPLEMENTING THE 2014 TANGIBLE PROPERTY REGULATIONS ("TPR") EXPLANATION OF TAX CHANGES TO 2014 BUSINESS TAX RETURNS

TPR is the new **retroactive** rulebook governing when tangible property may be expensed, or when it must be capitalized. Industry custom and accounting practices have limited meaning to the new rules.

When is TPR effective?

TPR has a mandatory adoption date for taxable years beginning on or after January 1, 2014. All TPR rulebook changes are effective for your 2014 and future tax years, and they are implemented by changing tax accounting methods in 2014, using various elections and filing Form 3115 to notify the Service that you have adopted the required changes in 2014. **ADDITIONALLY,** many of the TPR rulebook changes are also effective **retroactively to all prior tax years** with respect to any tangible property owned or leased by your business on January 1, 2014. Qualifying Small Business Taxpayers with either assets **or** revenue less than $10M may elect to receive relief from filing Form 3115 and to limit the retroactive date to January 1, 2014, however, there is no other small business relief.

Which categories of tangible property have rule book changes?

TPR governs three life cycles of tangible property: acquisition costs (Flowchart I), repair and maintenance ("R&M") costs (Flowchart II), and disposition costs (Flowchart III).

Acquisition costs are categorized through a mutually exclusive selection process, first testing for inventory status, next testing for material and supply status ("M&S"), and finally defaulting to fixed assets. A new De Minimis Election allows expensing for small $ costs. M&S costs are either Incidental, which may be expensed, or Non-Incidental which must be capitalized.

R&M costs are evaluated under new BAR standards and the change is retroactive to all prior years. The BAR standards define Betterments, Adaptations, and Restorations, all requiring capitalization. BAR standards are applied with respect to a Unit of Property, meaning an identical cost considered a capitalized improvement to one Unit of Property might be considered a deductible repair to another Unit of Property. A De Minimis Election allows for the expensing of small $ repairs. A favorable Routine Maintenance Safe Harbor may be adopted on Form 3115 to expense some larger $ repairs. To implement, taxpayers may be required to perform a look-back procedure or justify why not necessary.

How is my business and my 2014 income tax return affected by TPR?

1. All taxpayers will need to understand the new TPR rulebook. Taxpayers are affected differently depending on factors such as industry, activities, history, and magnitude of tangible property investment. Based on our assessment of how TPR impacts you, we will phone you to discuss or schedule a specific work-session. At that time we will be prepared to suggest and discuss with you an appropriate level of response for you to make to TPR, including implementation steps.

2. You should expect to utilize a new <u>De Minimis Election</u> on your 2014 tax return. We will discuss the Election options with you prior to tax filing. Taxpayers holding certain small buildings might also benefit from a <u>Small Taxpayer Safe Harbor Election</u>.
3. Other than electing <u>Qualifying Small Business Taxpayers</u>, we anticipate most taxpayers will be filing Form 3115 to notify the Service of adoption of the new required tax accounting method changes. We anticipate suggesting the adoption of a favorable <u>Routine Maintenance Safe Harbor</u> for most taxpayers. We will discuss these options with you prior to filing.
4. A level one response to the TPR will be limited to the steps outlined in (1) through (3) above.
5. A level two response to the TPR would include the steps outlined in (1) through (3) above, **AND**
   - A) Thoroughly evaluate 2014 R&M costs, noting if any changes from historic practice might suggest that a look-back procedure should be performed on any of 2011-2013 R&M costs.
   - B) Review the 12-31-13 depreciation schedules for TPR compliance and new opportunities.
   - C) Any changes to the tax depreciation schedules as a result of retroactive TPR, resulting from capitalizing items previously deducted in prior years, deducting items previously capitalized, changing depreciation methods or lives, or changing the definition of Unit of Property, are all accomplished on a 2014 Form 3115, calculating and reporting a positive or a negative adjustment labeled: "the 481(a) adjustment".
   - D) Numerous other elections or method changes exist, such as <u>Total Dispositions, Partial Dispositions, or Late Elections</u>, which might produce favorable opportunities for you. We will survey and present any options that might be favorable to you for your consideration.
6. A level three response would include these and any other agreed upon procedures.

<u>Will prior year tax be owed on any unfavorable retroactive changes for R&M costs?</u>

NO. Prior year tax returns are <u>not amended</u> under TPR and prior year tax, interest or penalty is <u>not</u> assessed. The filing of a F3115 under TPR to both adopt the new required tax methods of accounting **AND** report the cumulative effects of positive method changes, result in:

1. All prior year tax returns effectively receive amnesty with respect to TPR matters. Please note, this procedure will also work for changes to mitigate risk exposure on items that were questionably deducted under prior year rules.
2. Tax years 2014 through 2017 will bring any positive change (the 481(a) adjustment) into taxable income 25% per year in each of four years;
3. **AND** an equal amount of the positive change (the 481(a) adjustment) will represent <u>future depreciation deductions</u> (tax depreciation in excess of book depreciation) over the course of the remaining life of the item. Please note that other than real estate changes or land improvement changes; much tangible property is depreciated over five to seven years.
4. Points (1) through (3) above means there may be no significant change in future year tax beyond timing differences. For personal (vs real) property the timing differences should be small.

Revised: February 2015 by DiLorenzo & Company LLC. The information contained herein is general in nature and based on authorities subject to change. Applicability to specific situations is to be determined exclusively through consultation with your tax advisor.