DwightDarby&Company
Certified Public Accountants

February 16, 2015

This notice is to inform you about the Tangible Personal Property Regulations that are effective as of January 1, 2014 for the tax year ending December 31, 2014. These regulations were finalized in late 2014 but have been the subject of much debate. As of Tuesday, February 10, 2015, the American Institute of Certified Public Accountants (AICPA) updated CPA firms that they continue to express to the IRS their concerns about the administrative burdens associated with the regulations as well as trying to file the proper returns to adhere to these new regulations.

On Friday, February 13, 2015 the IRS provided some relief for small businesses which allows small businesses to implement these changes on a prospective basis and avoid completing and filing a Form 3115. The relief is generally available to small businesses, including sole proprietors, with assets totaling less than $10 million or average annual gross receipts totaling $10 million or less. The information within this notice is still important so that you properly record future repairs/maintenance, materials and supplies and capitalizable items in accordance with these regulations.

Therefore, in anticipation of preparing your tax return for 2014, we find it necessary to communicate the requirements we will be under as a result of one of the biggest tax law changes to come in many years. The new regulations apply to tangible property, repairs, maintenance, and supplies purchased in your business or rental activity. These regulations are mandatory for all taxpayers. We have summarized and included the most common new regulations in this notice for your reference. We urge you to read this notice thoroughly.

The new regulations produce such a change that if you were in business prior to 2014, these rules will most likely be considered a change in accounting method for income tax purposes. A change in accounting method requires the business to file Form 3115, Application for Change in Accounting Method. On this application, you may be required to report what the cumulative effect of this change in method would be on taxable income at the beginning of the year known as a "§481(a) adjustment".

You will need to become familiar with how the new regulations will impact your business.

While the new regulations will be burdensome in some regards, they also present many opportunities for tax planning and savings.

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Tangible Personal Property Regulations Overview

After several years of development the IRS issued final (revised) tangible property regulations which are one of the most widespread developments under the U.S. income tax code as it affects virtually all business taxpayers and will require a closer look at accounting policies and procedures for maintenance, supplies, and capital expenditures. The regulations must be followed by all taxpayers starting with tax years beginning on or after January 1, 2014 and the cumulative effect of the changes must be determined. The issue is whether a particular purchase is expensed outright (with a current tax deduction), or capitalized as an asset and depreciated over a certain number of years.

The following summary will try to take the complex topic that is the tangible property regulations and break down the various components so that you will better understand how to account for tangible property purchases, supplies and repairs.

Unit of Property

The regulations reference a new item, which they have labeled as a "Unit of Property" (UOP). The UOP becomes a very important issue as it determines whether an item can be expensed or whether it should be capitalized when placed in service. The distinction is based on whether the expenditure relates to a UOP as a whole or as a part of a UOP.

All of the components that are functionally interdependent make up a single UOP. Two or more components are functionally interdependent if you must place each of them in service at the same time for them to perform their intended functions. For example, a computer and a printer are considered two units of property because either could be been placed in service without the other. However, a car and its engine are considered one UOP, because one cannot function without the other.

New Rule: Materials and Supplies

Materials and supplies are defined as tangible property that is used or consumed in the business operations. The new rule states that any materials and supplies purchased during the year that are under $200 can be expensed immediately (previously there was no threshold). This means that the $50 stapler you purchase does not need to be capitalized and depreciated over multiple years, but can instead be expensed in the year of purchase. This rule is on an item by item basis, and therefore if you purchase multiple items on a $600 invoice you will need to examine if any of those items are over $200 to determine if they need to be capitalized.

Certain categories of materials and supplies are also allowed to be expensed outright. Consumption-type items can be expensed, such as fuel, water, and lubricants, as long as they are consumed within 12 months. Any UOP with a useful life of less than 12 months, regardless of the amount, can also be expensed. Items purchased for resale (inventory) do not follow these rules.

New Rule: Equipment Repairs

This category includes repairs to any and all assets owned by the business during the year, with the exception of building repairs which will be discussed later. <u>Every year there is an annual election</u> under the de minimis safe harbor to expense amounts paid for repairs as well as routine maintenance safe harbor.

De Minimis Safe Harbor Election: The de minimis safe harbor election presents taxpayers with the opportunity to accelerate deductions into the current year by allowing taxpayers to deduct amounts paid for a UOP per invoice (or per items as substantiated by an invoice). The de minimis safe harbor election requires that taxpayers have a capitalization policy substantiating the procedure and that the capitalization policy is followed on the books and records. This policy must be in place as of the first day of the tax year. The written procedure should address the policy to expense amounts paid for property costing less than a specified dollar amount, and/or property with a useful life of 12 months or less. Taxpayers with an audited financial statement may deduct, in accordance with their written capitalization policy, amounts paid for a UOP of less than $5,000. Taxpayers without an audited financial statement may elect to deduct up to $500 per invoice/unit in accordance with their policy. For example, if a taxpayer purchases 50 chairs for the business with an invoice totaling $22,500 (50 chairs at $450/each), a taxpayer with a written capitalization policy may elect to deduct the full $22,500 purchase price to reduce their taxable income.

Routine Maintenance Safe Harbor: Under the routine maintenance safe harbor for equipment repairs, an amount paid is deductible if it is for routine, recurring items that a taxpayer expects to perform to keep a UOP in its ordinarily efficient operating condition. Activities are considered routine only if, at the time the UOP is placed in service, it is reasonably expected that the maintenance will occur more than once during the class life of the property.

New Rule: Building Repairs

The new rules regarding building repairs are very complicated and require an in depth analysis in order to determine whether an amount should be capitalized and depreciated over the useful life or expensed in the current year.

There are a few safe harbor provisions aimed at routine maintenance and small businesses. When looking at amounts paid for building repairs taxpayers will have to determine if the repair is a betterment, adaption, or restoration. If it fits any one of these categories and is a material addition to the UOP, they will have to capitalize the repair. However if it does not fall under these rules, then there is the opportunity to expense the repair. These rules are very complex.

Routine Maintenance Safe Harbor: Under the routine maintenance safe harbor for building repairs, an amount paid is deductible if it is for routine, recurring items that a taxpayer expects to perform to keep a UOP in its ordinarily efficient operating condition. Activities are considered routine only if it is expected to occur more than once over a 10-year period.

Small Business Safe Harbor: The IRS issued a safe harbor for small businesses in order to alleviate some of the burdensome recordkeeping associated with the improvement standards. These small businesses can elect to deduct repairs, maintenance, or improvements to eligible buildings if the following conditions are met (on a per-building basis):

- Taxpayer has three-year average annual gross receipts of $10 million or less
- Taxpayer owns or leases buildings with an unadjusted basis of $1 million or less, and
- Total amounts paid during the tax year for repairs, maintenance, and improvements of the building do not exceed the lessor of:
    - 2% of the unadjusted basis of the building, or
    - $10,000

New Rule: Capitalize Repair & Maintenance Costs

The final regulations provide taxpayers with an annual election to opt out of deducting repair and maintenance costs if the taxpayer capitalizes them on its books and records. This election allows a taxpayer to align its tax treatment with capitalization policies used for book purposes and eliminate book-to-tax differences. Taxpayers may avoid the difficult and subjective rules applied in determining whether an expenditure must be deducted or must be capitalized. Unlike other elections in the final regulations, there is no option to file an amended return to make this election nor are you taking advantage of immediate tax savings.

New Rule: Partial Dispositions

A long time frustration for taxpayers was the treatment of portions of tangible property that are lost due to casualty or replaced as part of a repair. Before the final repair regulations were issued, companies were not allowed to deduct the portion disposed of for these cases, but the new regulations allow for a partial disposition. For instance, under the old rules if a roof was damaged in a storm and had to be replaced, the old roof would stay on the books and continue to be depreciated, while the new roof was added to the property and depreciated. However, now companies can elect to perform a partial disposition and recognize a loss on the value of the replaced property and take advantage of immediate tax savings.

The §481(a) Adjustment

The above new rules will require a calculation of the cumulative effect of the changes as of the beginning of the year. At a minimum, your business or rental will have a §481(a) adjustment if you:

- Expensed items in prior years which would have been capitalized under the new regulations and which would still have a remaining depreciable life.
- Capitalized items in prior years, which would have been expensed under the new regulations and which still have a remaining net depreciable value. (Note that leaving assets on the books as a depreciable asset when under the new regulations the asset would have been expensed, may result in loss of future depreciation on those assets if not included in a §481(a) adjustment.)
- Have assets still on the books with a remaining net depreciable value, which were replaced with a capital asset and would qualify for partial asset disposition under the new regulations.
- Have previously depreciated property using an incorrect method or life.

IN CONCLUSION

The above summary highlights the major changes and impact of the new regulations. **Adherence to the new rules <u>is not optional</u> and is required starting with tax years beginning on or after January 1, 2014.**

You will be required to file one or more Form(s) 3115. As a result, additional time will be required to prepare your 2014 income tax return. There will be an additional one-time fee related to the filing of Form(s) 3115 and will be determined based on your specific situtation. Even if no §481(a) adjustment is made the Form 3115 must be filed with certain elections made.

It is our belief that in most cases, it would not be cost effective to determine the effect, if any, of these new regulations on prior years. If you would like to explore this option further, please contact us to discuss your specific situation.

As part of these new guidelines you must have a capitalization policy in place and dated effective January 1, 2014. We have attached an example for you to use. Please forward us a copy for our files once you complete the policy.

Please contact us if you have any questions or would like assistance with any aspect of implementation of the new regulations. We look forward to working together this year.

Note: The most cumbersome part of the regulations is determining how to capitalize or expense improvements or the initial recording of a purchased or newly constructed building, including the disposition of a component of a building that in prior years is part of a larger asset. We can provide additional information to help you make determinations and/or recommend a cost segregation firm should you be making a large purchase or constructing of a building or improvements.

Note: See attached Capitalization Policy example and a Quick Summary of Final Tangible Property Regulations issued by AICPA.

ABC USA, Inc.
Capitalization Policy
Effective January 1, 2014

1. Purpose

   This accounting policy establishes the minimum cost (capitalization amount) that shall be used to determine the capital assets that are to be recorded in **ABC USA, Inc.'s** annual financial statements (or books).

2. Capital Asset definition

   A "Capital Asset" is defined as a unit of property that: (1) has an economic useful life that extends beyond 12 months; **and** (2) was acquired or produced for a **cost of $500/$5000 (choose $5,000 if receive audited financial statement)** or more. Capital Assets must be capitalized and depreciated for financial statement (or bookkeeping) purposes.

3. Capitalization thresholds

   ABC USA, Inc.'s. establishes **$500/$5,000** as the threshold amount for minimum capitalization. Any items costing below this amount should be expensed in **ABC USA, Inc.'s** financial statements (or books).

4. Capitalization method and procedure

   All Capital Assets are recorded at historical cost as of the date acquired.

   Tangible assets costing below the aforementioned threshold amount are recorded as an expense for **ABC USA, Inc.'s** annual financial statements. Alternatively, assets with an economic useful life of 12 months or less are required to be expensed for financial statement purposes, regardless of the acquisition or production cost.

5. Recordkeeping

   Invoices substantiating an acquisition cost of each unit of property shall be retained for a minimum of four years.

6. Materials and Supplies

   Materials and supplies purchased during the year that are under $200 can be expensed immediately.

Signed: ___________________________

Date: _____________________________