

## Collateral Issues to Consider in Tangible Property Regulations Accounting Method Changes



The tangible property regulations ("the repair regulations") provide rules for distinguishing deductible repair costs from capital improvements that must be recovered through depreciation. The final repair regulations are generally effective for tax years beginning after December 31, 2013, although taxpayers may opt to apply the rules for tax years that began after December 31, 2011 if the deadline for filing an election or accounting method change has not passed.

Accounting method changes adopted under the repair regulations will, in certain cases, affect the computation of other deductions or credits allowed under the Internal Revenue Code. Taxpayers should carefully consider these collateral consequences when quantifying the effect of changes made under the repair regulations. Some of these collateral consequences are section 199, section 263A, LIFO, and the ordering rule in section 263A. Each of these is discussed in more detail below.

**Section 199:** A taxpayer's permanent section 199 domestic production activities deduction could be reduced, and the projected effective tax rate increased, if the change made to comply with the repair regulations yields a significant section 481(a) adjustment in the taxpayer's favor. Conversely, if the adjustment is unfavorable to the taxpayer, the section 199 benefit may be increased.

**Section 263A:** A taxpayer's section 263A uniform capitalization (UNICAP) computation could be significantly affected, whether the section 263A method relates to inventory or self-constructed assets. The UNICAP rules generally require the

capitalization of direct costs and indirect costs that directly benefit or are incurred by reason of the performance of production or resale activities. The transition guidance to the final regulations generally permits repair method changes to be filed under the automatic consent procedures described in Revenue Procedure 2011-14. The transition guidance does not include a requirement that a taxpayer's section 263A methods for the costs being changed under the repair regulations also be in compliance with section 263A. Thus, a concurrent section 263A change is not required to be filed with changes made under the repair regulations. However, as described below, there may be collateral consequences to a taxpayer's section 263A computations as a result of a repairs section 481(a) adjustment.

**LIFO:** A taxpayer that uses the LIFO method for accounting for inventories must reduce the section 481(a) adjustment for repairs by allocating a portion of the adjustment to prior-year LIFO layers. In this case, the amount of the benefit that may be expected from a capitalization-to-repair method change would be reduced by the portion of the section 481(a) adjustment allocable to prior-period LIFO layers. Presumably, the IRS would favor an approach in which the taxpayer recomputes each prior layer; however, if the taxpayer lacks sufficient records to apply the repair expense to each prior layer, the three-year average method of Treas. Reg. section 1.263A-7(c)(2)(v) may be available to simplify the computation.

**Ordering rule:** A taxpayer must consider the ordering rules in the section 263A (UNICAP) regulations for computing section 481(a)

adjustments for multiple changes filed in the same year. The ordering rules provide that section 263A changes generally are deemed to occur before other method changes filed concurrently with the section 263A change. There is an exception to the general ordering rule for depreciation changes, which requires that the section 481(a) adjustment for depreciation be computed before the adjustment is computed under section 263A. This exception for depreciation changes does not apply to method changes for repairs. Accordingly, a taxpayer that files concurrent changes for (1) a depreciation method, (2) a section 263A method, and (3) a repair method would have to implement those changes and calculate the section 481(a) adjustments in that order.

### How KPMG Can Help

Taxpayers considering filing repair and maintenance method changes under the repair regulations should carefully consider the collateral consequences the changes may have on the computation of other income and deductions. KPMG LLP ("KPMG") recommends that taxpayers have discussions with our specialists, who can explain and determine the impact of any change in accounting method resulting from the repair regulations on the computation of other deductions or credits, including section 263A and section 199. In connection with these discussions, KPMG can assist taxpayers in quantifying the overall impact to tax positions as a result of changes made under the repair regulations.

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