

Final Tangible Property Regulations. Commonly Asked Questions & Answers



De Minimis Safe Harbor and Materials and Supplies

1. What if my book threshold is less than \$5,000 per item?

The de minimis safe harbor covers only amounts that are \$5,000 or less per item and that are expensed under the taxpayer's written policy for book purposes. If the book policy is less than \$5,000 (for example, is \$3,000 per item), then an item purchased in excess of the book threshold (for example, an item costing \$4,500) would presumably have been capitalized for book purposes and therefore ineligible for the safe harbor (the amounts must be expensed on the applicable financial statement). Thus, the items that qualify are those that are consistent with the book policy. The rationale is that as long as the taxpayer has an applicable financial statement (SEC filing, audited, or filed with government agency), then the threshold has been verified and approved by an independent auditor.

2. What if my book threshold is more than \$5,000 per item?

The safe harbor covers only the amounts expensed under the book policy to a limit of \$5,000 per item. If the book policy exceeds \$5,000, then the safe harbor will apply to items costing \$5,000 or less but will not cover the items that cost more than \$5,000. The preamble indicates that a taxpayer may agree with an IRS exam team that a higher threshold is reasonable and clearly reflects income. Alternatively, a taxpayer may choose to capitalize and depreciate the items that cost more than the \$5,000 safe harbor (other than most common types of materials and supplies, as discussed below). A few cases have

addressed whether a taxpayer's de minimis policy clearly reflected income prior to the issuance of the final regulations. See, for example, *Cincinnati, New Orleans & Tex. Pac. Ry. Co. v. United States*, 424 F.2d 563 (Ct. Cl. 1970) and *Alacare Home Health Services, Inc. v. Commissioner*, T.C. Memo. 2001-149.

3. What is the interaction of the de minimis rule with materials and supplies (for example, amounts less than \$200)?

All materials and supplies costing no more than \$5,000 per item that are expensed in the year of purchase under the taxpayer's written book policy also must be expensed in the year of purchase under the de minimis safe harbor, if elected. Unlike the 2011 temporary regulations, the final regulations do not permit selective capitalization of materials and supplies. The only exceptions to that rule are for certain rotatable and temporary spares that are capitalized and depreciated or with respect to which the optional method of accounting for spares is used. In addition, any materials and supplies or component parts that are expensed in the year of purchase may still be required to be capitalized under either sections 263(a) or 263A if they are costs of another self-constructed asset or improvement, if applicable.

4. Is the annual de minimis election made at the subsidiary level or at the consolidated or group level? Can there be one written policy for the group?

The annual election to follow the de minimis safe harbor is made on an entity-by-entity basis. The parent of a consolidated group will make the annual election for those subsidiaries that it lists in the statement and all other group

members may choose to make the election separately. Additionally, if there is one overall written policy for the group, then all members may generally rely on that policy. The written policy must be in place at the beginning of the year for which the safe harbor is elected.

5. Do the rules apply to a controlled foreign corporation?

Under the section 964 regulations, methods of accounting and elections generally apply to a controlled foreign corporation and certain other related foreign parties in the same manner as they apply to a domestic corporation. Once a "significant event" occurs, a CFC is generally treated as adopting a method of accounting. Thus, absent specific guidance to the contrary, the elections and methods under the repair regulations are applicable to a CFC.

6. What is the definition of an applicable financial statement?

An applicable financial statement is, in descending priority—

- (i) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);
- (ii) A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for-
 - A. Credit purposes;
 - B. Reporting to shareholders, partners, or similar persons; or
 - C. Any other substantial non-tax purpose; or

(iii) A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the Internal Revenue Service).

If an item is expensed on an applicable financial statement of another group member, that generally will satisfy the requirement that the amounts be expensed on an applicable financial statement.

7. Does section 263A apply to amounts expensed under the de minimis safe harbor?

See response to question 3 above. Materials and supplies or other costs that are expensed under the de minimis rule may be required to be capitalized as a cost of a larger self constructed asset, improvement, or inventory under either sections 263(a) or 263A.

Repairs vs. Improvements

1. Is there a downside to making the election to follow book capitalization for improvements to property?

The election to follow book capitalization is an annual election that applies only to additions/improvements in the year of election. The election is irrevocable. Thus, if a taxpayer makes the election, it will be precluded from filing a method change in a subsequent year to claim the items for which it made the election as repairs via a section 481(a) adjustment. If the election is not made in a particular year, then the capitalization/unit of property rules in the final regulations would apply.

2. Does a component that is expensed because it is less than \$5,000 have to be capitalized as an improvement to another unit of property? What if the component costs more than \$5,000?

Potentially, if the costs are allocable under sections 263(a) or 263A to another self constructed asset, improvement, or inventory. See responses to questions 3 and 7 above.

3. If I make the book conformity capitalization election, can I treat some items as deductible repairs for tax purposes?

No. The election applies to all repair and maintenance costs capitalized for book purposes for the year, regardless of how

the costs would otherwise be treated for tax purposes. A taxpayer cannot selectively apply the safe harbor to choose to deduct for tax purposes certain items that are capitalized for book purposes. Repair and maintenance costs deducted for book purposes, however, remain potentially deductible for tax purposes, depending on whether they are improvements under the standards of the repair regulations.

4. Is the book conformity capitalization election made for the entire group or entity by entity?

The election to follow book capitalization is made on an entity by entity basis on an annual basis. The parent of a consolidated group will make the annual election for those subsidiaries that it lists in the statement and all other group members may choose to make the election separately.

Dispositions

1. Are retroactive general asset accounts still necessary for building property?

The proposed regulations (which allow early adoption in 2012 or 2013) permit a retirement loss for any portion of a building by annual election. In a complete reversal from the earlier temporary regulations, the proposed rules do not permit a partial retirement if the building is held in a general asset account. Under this revised approach, a taxpayer elects to retire the portion of the building by recognizing its allocable basis on the return for the year of the disposition (no affirmative statement is required). Unlike the 2011 temporary regulations, the proposed rules do not treat a structural component of the building as a separate asset for disposition purposes (the original structural components are part of the building asset) and therefore eliminate the need to define the term "structural component."

2. What is the downside to electing general asset accounts under the revised rules?

The downside to making a general asset account election under the proposed regulations is that partial dispositions are not permitted for an asset in a general asset account. Notwithstanding this limitation, some companies (typically those in loss positions) may choose to utilize the GAA rules to increase income

upon future year dispositions. The use of GAAs also may be attractive to companies who place a high priority on simplifying their systems for tracking and accounting for asset dispositions.

3. How is the partial disposition election made? How far back can I go to make the election?

The election for a partial disposition is made by reporting the gain or loss on the return for the year of disposition. No affirmative statement is required. Early election is permitted for 2012 (an extended period is provided to amend the return) or 2013.

4. If my building improvements are not included in GAAs and I physically disposed of them in a prior year, am I using an improper method by continuing to depreciate them?

It is not clear under the proposed rules whether a taxpayer may continue to depreciate an "improvement" to a building after the improvement has been physically disposed of. This may be the case, for example, where a lessor remodels tenant space each time it leases the space to a new tenant. In that case, the lessor may have numerous improvements on its books that it continues to depreciate but that have been physically disposed of in a prior year. Under current transition guidance, a taxpayer may file a method change to write off the basis (via a section 481(a) adjustment) of improvements that were physically retired in a prior year. Going forward, however, it's not clear that a method change will be permitted given the change to an annual election.

**Have another question for us?
Need clarification on something?**

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