TANGIBLE PROPERTY REGULATIONS *EXPLAINED*

TANGIBLE PROPERTY TAX METHODS

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A LOOK AT TANGIBLE PROPERTY REGULATIONS

WHAT YOU NEED TO KNOW TO BE COMPLIANT

The Tangible Property Regulations (TPRs) provide guidelines for building owners to determine to expense or capitalize costs spent on property from 2014 forward. If a building owner and their tax professional have not discussed and planned for the TPRs, both parties will overlook the opportunities. Since 2013, the CPA community has been seeking resource partners who are experts in segregating components of commercial buildings for their clients to take advantage of this underutilized yet mandatory law. These regulations are not just an advantageous opportunity for building owners; this is the law.

Under code section 263(a)(1-3), the Tangible Property Regulations are the most significant tax change for real estate owners and investors since the Tax Reform Act of 1986. The repair regulations codify and define which expenditures on assets currently in service can be written down as an expense and which ones need to be capitalized. The regulations also clarify confusion and are designed to reduce conflicts from previous court cases and regulations. The TPRs generally define which expenditures make an asset better and which keep the asset in its current operating condition.

WHY WERE THE REGULATIONS WRITTEN?

Tax law has long required businesses to distinguish between deductible business expenses and non-deductible capital expenditures for tangible property. Determining whether an expense qualifies as a deductible repair or must be capitalized often involves a thorough review of a taxpayer's specific facts and circumstances

Due to the subjective nature of these decisions, there has been significant controversy between taxpayers and the IRS for years.

To address this, the final Tangible Property Regulations were introduced, which combine decades of case law and other authorities into a clearer framework for determining whether certain costs can be deducted immediately or must be capitalized. These regulations offer several elective, simplifying provisions that can be applied prospectively, including the De Minimis Safe Harbor (DMSH), the Safe Harbor for Small Taxpayers (STSH), and the election to capitalize repair and maintenance costs based on company books and records.

Prior to the final regulations issued on September 17, 2013 (Treasury Decision 9636), the IRS and taxpayers relied on inconsistent case law and administrative rulings for guidance on repair versus capitalization decisions. Now, with these regulations in place, taxpayers have a more predictable and structured method to determine the correct treatment of tangible property expenses.

WHAT IS THE IMPACT?
COMPLY VS. IGNORE

THE TANGIBLE PROPERTY REGULATIONS ARE *NOT OPTIONAL.*

The final Tangible Property Regulations (TPRs) apply to all taxpayers who incur costs to acquire, improve, or produce tangible property. Effective since January 1, 2014, these regulations are mandatory and outline how to classify expenses as either repairs (immediately deductible) or improvements (capitalized and depreciated).

Compliance with the TPRs is advantageous, offering opportunities for immediate tax savings through provisions like the safe harbor for repairs and maintenance. However, non-compliance can lead to the IRS denying past, present, and future depreciation claims, resulting in substantial financial loss, penalties, and interest.

To correct non-compliance, taxpayers may need to file IRS Form 3115 to adjust their accounting methods, a complicated process. TPTM specializes in ensuring full compliance with these regulations, helping businesses accurately classify their property expenses and maximize tax savings while avoiding costly IRS penalties.

UNIT OF **PROPERTY**

Each building, when it is not connected to another structure, is considered an individual Unit of Property (UOP). The proper identification of the UOP is essential when making decisions about whether a cost should be capitalized or expensed, as the IRS uses the UOP framework to determine how expenses related to repairs, improvements, or replacements are treated for tax purposes. Misidentifying the UOP can lead to incorrect capital versus expense decisions, potentially resulting in lost tax savings or non-compliance with IRS regulations. For example, if a taxpayer incorrectly defines their building's UOP, they may mistakenly capitalize a repair that should have been expensed, or vice versa. By understanding the UOP rules, taxpayers can ensure they are classifying costs appropriately and taking full advantage of available tax deductions. At TPTM, we specialize in helping property owners accurately assess their UOP and navigate these critical decisions to maximize tax benefits while maintaining compliance.

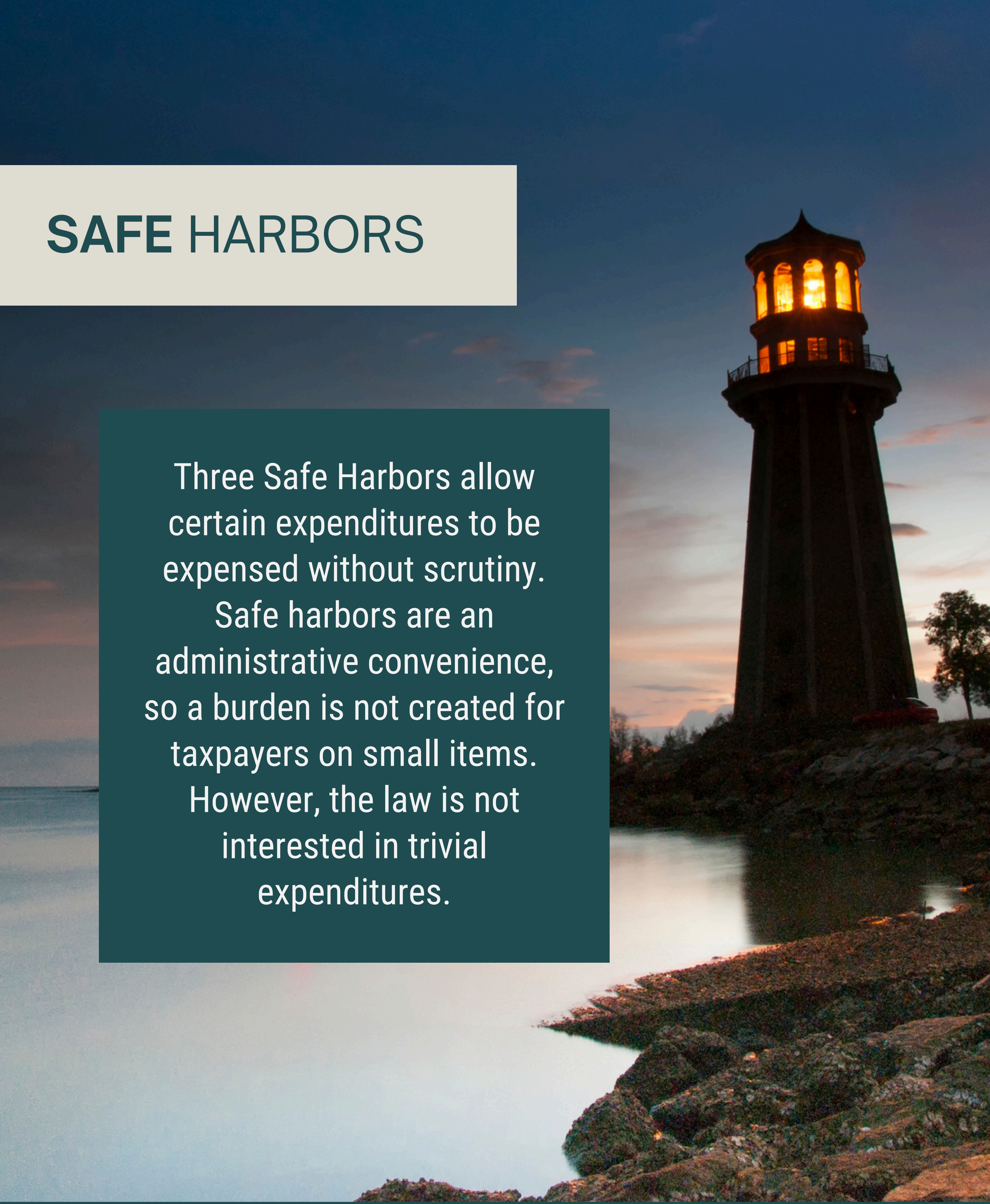
BUILDING **SYSTEMS**

WHY WOULD I BE INTERESTED IN DEFINING *MY BUILDING SYSTEMS?*

Once the Unit of Property (UOP) is determined, buildings are further broken down into specific building systems. Each building system must be accounted for separately within the property. These systems include up to nine categories, such as HVAC, plumbing, electrical, and fire protection systems. While not every building will have all nine systems (for example, a small warehouse may not have escalators or elevators), most buildings will have key components like fire protection and security systems. Understanding the value of each building system allows property owners to make informed capital vs. expense decisions, optimizing tax benefits and compliance with regulations.

NINE BUILDING SYSTEMS

- HVAC
- Plumbing
- Electrical
- Escalators
- Elevators
- Fire Protection & Alarm
- Security
- Gas Distribution



SAFE HARBORS

Three Safe Harbors allow certain expenditures to be expensed without scrutiny. Safe harbors are an administrative convenience, so a burden is not created for taxpayers on small items. However, the law is not interested in trivial expenditures.

DE MINIMUS SAFE **HARBOR**

The De Minimis Safe Harbor (DMSH) provides a valuable tax benefit for businesses making smaller purchases under $2,500, allowing them to expense these items in the current tax year rather than capitalizing them. Here's what you need to know about DMSH:

- Expenditures under $2,500 qualify.
- "De minimis" is Latin for "minimal things."
- It is an annual election that must be made each year.
- It can only be used in the current year and cannot be applied retroactively.
- The taxpayer must have an invoice for the expense, and each item on the invoice must be less than $2,500.
- Example: A $2,400 computer qualifies, but if shipping and installation bring the total to $2,700, it does not qualify.
- Taxpayers can ask vendors to separate costs, like installation, on a different invoice to maintain DMSH eligibility.
- This applies to building components, but not when part of a larger renovation project.

By carefully managing invoices, taxpayers can maximize the benefits of the DMSH for their smaller purchases.

SMALL TAXPAYER SAFE **HARBOR**

The Small Taxpayer Safe Harbor (STSH) is a tax provision designed to help small businesses expense certain costs associated with building improvements. Here are the key points:

- Annual election: Must be made each year to take advantage of the safe harbor.
- Eligibility: Available to taxpayers with average gross receipts of $10 million or less.
- Expense Limit: Allows taxpayers to expense the lesser of 2% of the building's adjusted basis or $10,000 annually.
- DMSH Integration: All expenditures under the De Minimis Safe Harbor (DMSH) count toward this limit.
- Land Improvements Excluded: Expenditures related to land improvements do not count toward the 2% or $10,000 limits.

This safe harbor is beneficial for smaller businesses looking to deduct building-related expenses, but it's important to track and manage total expenditures to stay within the limits set by the STSH.

ROUTINE MAINTENANCE SAFE **HARBOR**

The Routine Maintenance Safe Harbor (RMSH) is a valuable but often overlooked provision that allows taxpayers to expense costs related to routine maintenance on an asset. Key points include:

- Expensing Routine Maintenance: Allows taxpayers to expense costs for maintenance expected to be performed regularly.
- No Annual Election: Unlike other safe harbors, RMSH does not require an annual election. All taxpayers are automatically considered to follow this rule.
- Definition of Routine Maintenance: Covers any expenditure that is reasonably expected to be repeated within 10 years for the upkeep of an asset.
- Limitations: The maintenance expense cannot improve, enlarge, or materially increase the efficiency of the building component.

This safe harbor is particularly useful for ongoing maintenance costs such as HVAC repairs or roof patching, which help keep assets in normal operating condition without requiring capitalization. Understanding and applying the RMSH can lead to significant tax savings for property owners.

RABI RULES

RESTORATION

ADAPTATION

BETTERMENT

IMPROVEMENT

RABI RULES

When Safe Harbors do not apply, taxpayers must consider the RABI rules to determine whether an expenditure must be capitalized or can be expensed.

- Restoration (R in RABI): If the expenditure occurs within two years of occupancy or the component is in a state of total disrepair, it must be capitalized as a restoration. This ensures that significant repairs or replacements restoring the asset to its former condition are not expensed.
- Adaptation (A in RABI): If the expenditure changes the original intended use of the asset, it must be capitalized. Any adaptation of a component for a new or different use than originally intended requires capitalization.
- Betterment (B in RABI): If the expenditure makes the component more than 10% more efficient, larger, or significantly more valuable, it must be capitalized. This applies to betterments where the asset is enhanced beyond its original condition.
- Improvement (I in RABI): If the expenditure affects more than 33% of all like components, it must be capitalized. This rule ensures that major improvements affecting a significant portion of an asset are capitalized rather than expensed.

If an expenditure repairs a component to maintain its everyday normal operating condition, and it is more than two years after occupancy, it can typically be expensed. This framework helps ensure compliance with IRS regulations while maximizing tax benefits.

OPPORTUNITIES UNDER § 481

The Tangible Property Regulations (TPRs) are mandatory, requiring all taxpayers to comply. However, there is flexibility under IRS Code Section 481(a) for taxpayers to revisit and adjust their depreciation schedules. This allows businesses to expense repairs that were previously capitalized, provided those repairs can now be expensed under current TPR rules. Initially, the IRS warned that failure to do so could result in disallowance of future depreciation.

The IRS has since clarified that this risk primarily applies to businesses with over $10 million in average annual gross receipts (AAGR). For businesses with less than $10 million in AAGR, adjusting depreciation schedules with a Section 481(a) adjustment is optional. If no adjustment is made, the IRS will not disallow future depreciation, as long as the business remains under the $10 million threshold.

Eligibility for making a 481(a) adjustment under Section 263(a) depends on whether the taxpayer has been following the RABI rules—Restoration, Adaptation, Betterment, Improvement—since 2015. The good news is that if only the safe harbors (DMSH, STSH, RMSH) have been applied in expense versus capitalization decisions, the taxpayer can still take advantage of a 481(a) adjustment to maximize tax savings.

PARTIAL ASSET DISPOSITION

ABILITY TO WRITE OFF ASSETS THAT ARE *NO LONGER IN USE*

A PAD allows a building owner to write down the remaining depreciable basis of items removed during a renovation, as well as the costs for the removal and disposal of those items. You can receive a tax deduction in the current year if you own commercial property, but it is a “use it or lose it” opportunity. Failure to write down the remaining basis in the tax year the renovation was performed will permanently negate the opportunity.

A partial asset disposition will also eliminate duplicate assets on your depreciation schedule further eliminating recapture at the time of sale.

- Roof Repairs
- Replacing Lighting
- Resurfacing Parking Lots
- Replacing Doors and Windows
- Interior or Exterior Painting
- Replacement of HVAC
- Tenant Space Reconfigurations
- Common Area Renovations

RESOLUTION

The Tangible Property Regulations (TPRs) are highly complex, and the IRS enforces them using a "carrot and stick" approach. When properly followed, the TPRs offer significant opportunities for tax savings, such as allowing certain expenses to reduce taxable income in the current year. However, the penalties for failing to comply can be severe, including potential disallowance of deductions and back taxes with interest.

Before performing a **Cost Segregation Study**, it is crucial that any assets eligible for expensing under Section 263(a) are properly expensed. This ensures that taxpayers are in compliance with the TPRs and maximizing their available deductions.

With many years of experience and specialized knowledge, TPTM is uniquely qualified to help identify past expenditures that can now be capitalized or expensed. TPTM also provides expert guidance to taxpayers in making strategic decisions about building renovations or repairs, ensuring these expenditures are expensed whenever possible to reduce their current tax liabilities. This approach not only lowers the immediate tax burden but also helps minimize long-term capital gains tax upon the sale of the property.

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