March 27, 2015

Dear Friends and Clients,

We here had a number of conversations about the following issue over the past few months. This letter is an attempt to clarify the issues.

The IRS has implemented the tangible property regulations (TPRs) (T.D. 9689) effective for taxable years ending on or after January 1, 2014. This new guidance determines whether certain expenditures are required to be capitalized or expensed, the tax treatment of materials and supplies, and if the remaining basis in assets partially disposed of can be written off. Taxpayers with depreciable property are generally subject to these regulations in some manner.

The TPRs are complex and must be addressed on your 2014 tax return. Some of the issues facing taxpayers are:

- Application of the TPRs to all assets with remaining basis,
- Changes to internal procedures to comply with the TPRs,
- Filing one or more IRS Forms 3115*, Application for Change in Accounting Method*,
- Adjusting 2014 taxable income for the appropriate amount of income or expense if changes are made retroactively, and
- Making annual elections.

In response to stakeholders, including AICPA and other professional organizations, the IRS issued additional guidance on February 13, 2015 to allow certain qualified taxpayers to choose a simplified method of implementing the TPRs. The IRS may publish additional information on this subject.

A qualified taxpayer is defined as each trade or business that has less than $10 million of tax assets or total annual gross receipts that averaged less than $10 million over the past three tax years. This new guidance provides for implementation of the TPRs on a cut-off or prospective basis beginning with the 2014 tax return instead of filing various Forms 3115, *Application for Change in Accounting Method*, for prior tax years.

Qualified taxpayers have the opportunity to take advantage of this simplified method which allows the TPRs to be applied prospectively, not retroactively. However, by doing so, taxpayers will lose the opportunity to:

- Adopt the benefits (if any) retroactively. Adopting the TPRs for tax years prior to 2014 may increase deductions or income on the 2014 tax return. To date, we have not performed the analysis required to make this calculation.
- Obtain IRS audit protection. Applying the TPRs retroactively prevents the IRS from making adjustments to prior year depreciation.
- Define a unit of property. Under the TPRs, taxpayers can clearly define a unit of property. Most taxpayers find it beneficial to elect a large unit of property so that when a portion of it is disposed of, the entire asset can be written off. If the TPRs are implemented prospectively, the IRS may define your unit of property in a way that is not beneficial to you.
- Deduct removal costs. When an asset is purchased and a portion of it is disposed of immediately (for example, the roof on a building is replaced), taxpayers can generally write off the portion of the purchase price identified for the disposed portion of the asset. If the TPRs are implemented prospectively, you lose the ability to apply this provision to removal costs capitalized in the past.
- Recapture depreciation. Depreciation recapture applies when you dispose of property, regardless of whether it is sold or exchanged for other property or services. Upon disposition of an asset, including the sale of all assets if your business is sold, depreciation previously deducted is recaptured as ordinary income instead of as a capital gain. By implementing the TPRs retroactively, these assets are effectively removed from your asset list and there is no recapture. Taxpayers with a large number of fully depreciated assets generally find this provision beneficial.

Professional standards dictate that we correspond with you to determine how to proceed. Options available to you are shown below. Please review these options and let us know how you would like to proceed.

1. **Apply TPRs retroactively:** After you inform us that you would like us to proceed, we will perform a detailed analysis of your prior year tax returns and depreciation schedules to identify assets affected by the new regulations. Based on the results of our work, we will recalculate prior year depreciation in accordance with the TPRs and prepare Form 3115, as needed. This adjustment could result in either a positive or negative adjustment to your taxable income.
2. **Estimate benefit/cost**: We can perform a cursory review of your assets to determine whether implementing the TPRs retroactively will save or cost you tax dollars in the current year. This analysis must be performed for each asset subject to the TPRs.
3. **File a zero Form 3115 and apply the TPRs prospectively**: File Form 3115, *Application for Change in Accounting Method*, showing no change

in income or expenses for prior years in order to obtain audit protection and other potential benefits.

4. **Apply the TPRs prospectively without filing Form 3115**: If you select this option, you understand that this choice is permanent and cannot be changed once your 2014 return(s) are filed.

The TPRs include many elections that may impact your taxes, and we recommend that you schedule a meeting with us to discuss them in detail.

- **Safe harbor election for materials and supplies**: Provides taxpayers a de minimis safe harbor to expense up to $200 in materials and supplies. In addition, stand by and emergency spare parts are expensed as materials and supplies instead of being capitalized. Emergency, rotable, stand by, and temporary spare parts can be capitalized, if beneficial, under this election.
- **De minimis safe harbor**: Allows taxpayers to deduct up to $500 of expenditures ($5,000 if applicable financial statements are prepared), regardless of whether the expenditure meets the definition of a capitalizable expense. Larger expenditures may be deductible but will be subject to a greater level of scrutiny. The IRS is currently evaluating whether the de minimis thresholds are appropriate or if they should be greater.

Please acknowledge how you want to proceed. We recommend you schedule a meeting with us to discuss the applicable elections under the TPRs and your options if you have further questions on this important matter.

We appreciate the opportunity to serve you.

Sincerely,

Catherine A. Tardy, MBA, CPA, CVA, CGMA

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