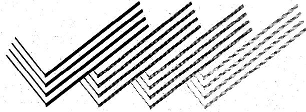

Villanueva
& Company PC

Certified Public Accountants

December 1, 2012

To Our Beloved Clients,

After $2 billion in combined spending this election season, the American public voted to keep things exactly the same as before, since it's apparently working so well. We can now safely say that either all of the United States' problems have been magically fixed forever, or this country is doomed, depending on who you talk to. Or the country is somewhere in between. We still have the same uncertainty today that we did before the election that makes planning for income taxes challenging, to say the least.

We do know however that there have been some rather sweeping changes to the tax code which we would like to bring to your attention, particularly in the asset capitalization rules regarding repairs, maintenance, and supplies. The new temporary regulations go into effect in retroactively to January 1, 2012 and have the potential to affect even your prior year returns, depending on the whim of the Internal Revenue Service.

UPDATE: The IRS has announced that the new capitalization rules will be delayed until January 1, 2014. Sounds like there was a bit of pushback from the business community, so more discussions will take place. We will still publish this as we would like you to be aware of what's in play in the future.

The Old Rules

In years prior, businesses were required to capitalize any expenditure for an asset that was expected to last longer than one year, then depreciate it over a prescribed number of years. This included expenditures for repairs to assets that would:

- materially extend an asset's useful life,
- change or improve its function, or
- increase the value of the asset.

This produced an interesting effect where a business could make major repairs to an asset that had been damaged, such as a building's roof, then expense the entire amount as a repair in one year. A building has a long depreciation life (39 years), yet a roof is expected to need major repairs a few times during the building's lifetime. The Tax Courts repeatedly upheld this interpretation of the Tax Code, most notably in a FedEx case where replacement engines in its planes were allowed to be expensed.

Interestingly, the cost of an asset didn't matter under the old rules; it only mattered that the asset was expected to last beyond one year. So there was no concept of a "minimum capitalization policy", where immaterial asset expenditures could be expensed rather than capitalized and depreciated.

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The New Temporary Regulations

The IRS, never one to miss an opportunity to confuse and to make sure small and medium businesses are hit hardest, is implementing temporary regulations that will fundamentally change how costs must be capitalized.

Though they're called "temporary", these regulations have the effect of law once implemented. The IRS has a few years to finalize these before they become permanent, but until then they are indeed binding. The new rules address materials, supplies, rotable spare parts, repairs, and maintenance costs in such a way as to make it more likely that businesses will have to account for supplies and materials inventories and to capitalize repair and maintenance costs that would normally have been expensed.

Materials and Supplies:

There's a new de minimus rule for materials and supplies that allows immaterial and incidental items to be expensed if they're under $100 per unit and meet certain conditions. That sounds a little stingy, but at least it was a step in the right direction. However, for those materials and supplies that are not incidental, they must be capitalized into inventories and deducted in the year used. Smaller business may have to now account for the use of supplies and materials. Companies who issue annual audited financial statements (for non-tax reasons) can qualify for a larger exemption amount, but for most small businesses the cost of an audit would be otherwise unnecessary and prohibitive. So big businesses will get an advantage that will not be shared by small businesses.

Repairs:

The new rules instruct taxpayers and the Tax Courts to change from a "Does it qualify as a repair? Should we capitalize it?" approach to a "Capitalize it first, then *maybe* we'll permit you to reclassify it as a repair." approach.

This may not seem significant, but the change in approach is designed to mire the taxpayer in the difficult capitalization rules first before they can even consider if the expenditure can be expensed as a repair. Under the old rules, if an asset fell into disrepair, the cost to restore the asset to its original function could be expensed if the repair met certain conditions. Now, the rules specifically state that the cost to restore an asset to its original condition must be capitalized. Repairs to structural components of buildings must be capitalized. The regulations specifically count what number of HVAC units can be replaced on a building and still qualify as a repair. There are numerous other rules, but gone are the days where businesses could simply write off a roof replacement as a repair expense.

Maintenance:

Maintenance must be part of a regular and ongoing process in order to qualify as a deductible expense. Thus, if an activity that would otherwise be considered maintenance were performed only once on an asset during its class life, the expense might have to be capitalized. As such, the rules could affect a prior year

maintenance expenditure, but it isn't clear if the IRS and the courts would consider the taxpayer's intentions and expectations when they originally implemented the maintenance program, or if they would instead use the power of hindsight to their favor.

Effect on Prior Years and Administrative Headaches:
The rules are written in such a way that they represent a change in accounting method. A taxpayer would normally have to file a Request for Change in Accounting Method Form with the IRS, then accrue and pay the difference in tax resulting from the change over four years. Conversely, under the new rules the taxpayer might be able to expense an asset that was previously capitalized, and thus claim a refund of prior year taxes. Until the rules are clarified, we don't know what the IRS' intentions are with regard to this accounting change. We're pretty sure that no one wants to pay us to review your prior year repair expenses and recapitalize them just so you can pay more tax, so we're hoping to see some guidance on this.

Conclusion
The items above are just a few of the new changes that are already scheduled to go into effect backdated to January 1, 2012. The new rules are confusing, representing a fundamental change in the way most businesses deduct repairs and capitalize assets. Businesses are more likely to have different bases for assets under tax law versus on their books. Small to medium businesses will be disparately impacted than larger corporations, so don't expect a whole lot of lobbying from the big companies to fix this.

If your business (or rental) owns assets that require repair and maintenance, you will be impacted by these new rules. If you'd like more information about the new regulations or if you'd like to review how the changes will specifically affect your business, please contact us to arrange for a meeting.

Very truly yours,

Villanueva & Company, P.C.