



Tax News Flash

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Fourth Quarter Federal Tax Developments

The following material is courtesy of RIA Checkpoint, with some commentary by Accuity.

Payroll tax cut temporarily extended. The Temporary Payroll Tax Cut Continuation Act of 2011 was enacted late last year. It temporarily extends the two percentage point payroll tax cut for employees, continuing the reduction of their Social Security tax withholding rate from 6.2% to 4.2% of wages paid through Feb. 29, 2012. Shortly after its passage, the IRS instructed employers to implement the new payroll tax rate as soon as possible in 2012 but not later than Jan. 31, 2012. The law also includes a “recapture” provision, which applies only to those employees who receive more than \$18,350 in wages during the two-month period (i.e., two-twelfths of the 2012 wage base of \$110,100). This provision imposes an additional income tax on these higher-income employees in an amount equal to 2% of the amount of wages they receive during the two-month period in excess of \$18,350 (and not greater than \$110,100). In addition, under the new law, the social security tax rate for a self-employed individual remains at 10.4%, for self-employment income of up to \$18,350 (reduced by wages subject to the lower rate for 2012). Congress is going to try to negotiate a deal to extend the payroll tax cut for all of 2012. If a deal is struck to extend it for the full year, the recapture provision for employees would not apply.

Credit for hiring veterans extended and enhanced. A law enacted last November extended and enhanced a credit for hiring qualified veterans. Before the law was passed, the credit would have been available only if the qualified veteran were hired before Jan. 1, 2012, and only certain veterans were considered qualified veterans. The new law extends the credit for hiring qualified veterans, adds two new classes of veterans who are considered qualified veterans, increases the credit for hiring certain qualified veterans, “fast-tracks” the process for certifying that an individual is a qualified veteran, and provides tax-exempt employers with a credit against payroll tax for hiring qualified veterans. The credit amount varies depending on a number of factors. It can be as high as \$9,600 for hiring a qualified disabled veteran. For an employer to qualify for the credit, the qualified veteran must begin work for the employer before Jan. 1, 2013 and other requirements must be met.

New rules for deducting or capitalizing tangible property costs. The IRS has issued new regulations for determining whether amounts paid to acquire, produce, or improve tangible property may be currently deducted as business expenses or must be capitalized. The regulations will affect virtually all taxpayers that acquire, produce, or improve tangible property. See detailed article later in this Alert.

New foreign asset reporting guidance and form. The IRS issued detailed guidance on the new law requiring individuals with an interest in a “specified foreign financial asset” during the tax year to attach a disclosure statement to their income tax return for any year in which the aggregate value of all such assets is greater than \$50,000 (or a dollar amount higher than \$50,000 as the IRS may prescribe). In addition, the IRS issued Form 8938 (Statement of Specified Foreign Financial Assets), which individual taxpayers will use starting in the 2012 tax filing season to report specified foreign financial assets for tax year 2011.

Note that this reporting regime is IN ADDITION TO the FBAR form that is required to be filed with Treasury before June 30. Heavy penalties apply for noncompliance.

Standard mileage rates flat or lower. The optional mileage allowance for owned or leased autos (including vans, pickups or panel trucks) is 55.5¢ per each business mile traveled after 2011. For 2011, it was 55.5¢ for miles driven after June 30 and 51¢ per mile for miles driven before July 1. Further, the 2012 rate for using a car to get medical care or in connection with a move that qualifies for the moving expense deduction is 23¢ per mile. For 2011, it was 23.5¢ for miles driven after June 30 and 19¢ per mile for miles driven before July 1.

New Form 8949 replaces Form 1040, Schedule D-1. Many transactions that, in previous years, would have been reported on Form 1040, Schedule D or D-1 must be reported on Form 8949 if they occurred in 2011. Specifically, a taxpayer uses Form 8949 to report:

- The sale or exchange of a capital asset not reported on another form or schedule,
- Gains from involuntary conversions (other than from casualty or theft) of capital assets not held for business or profit, and
- Nonbusiness bad debts.

The taxpayer uses Schedule D to figure the overall gain or loss from transactions reported on Form 8949 and to report capital gain distributions not reported directly on Form 1040, line 13, a capital loss carryover from 2010 to 2011, and certain specialized items.

Massive New Capitalization/Expense Regulations Released! A Must-Consider for All Taxpayers with Depreciable Property

Generally, costs that are incidental and do not add materially to the value of the property nor appreciably prolong its useful life are deductible as repairs. Costs for materials or supplies consumed during a year are also generally deductible. However, costs for permanent improvements that increase the value of the property, restore its value or use, substantially prolong its useful life, or adapt it to a new or different use must be capitalized and then deducted over time through depreciation or amortization.

The appropriate treatment of costs incurred in connection with the acquisition, production, or improvement of tangible property is an oft disputed issue between taxpayers and the IRS. The controversial nature of these costs is due in large part to a perceived lack of clear and comprehensive guidance in the current final regulations. In an attempt to rectify this deficiency, the IRS issued new proposed and temporary regulations on December 23, 2011. These new temporary regulations are generally effective for tax years beginning on or after January 1, 2012 and replace the current proposed regulations issued in 2008.

Accounting Method Change.

Beginning in 2012, taxpayers likely will have to change their method of accounting to conform to the new temporary regulations. This will require that taxpayers file Form 3115, generally no small task, and compute an adjustment to catch up their taxes corresponding to what would have happened if the new regulations were applied retroactively.

The *de minimis* rule described below is effective on a cut-off basis, and thus will not require this retroactive adjustment; but the other issues will.

The IRS is expected to issue additional guidance to provide taxpayers with “automatic change” procedures to change their methods of accounting to conform to the new regulations and compute the adjustment discussed above.

De Minimis Rule.

All taxpayers have been, and still are, allowed a “capitalization threshold” of \$100. For individual cost items under the threshold, a taxpayer generally doesn’t have to worry about whether the item has to be capitalized; it can simply be expensed.

Under the old regulations, a taxpayer could adopt a higher capitalization threshold if (1) a taxpayer has an applicable financial statement (“AFS”), which either needs to be audited or provided to a government agency for non-tax purposes; (2) the taxpayer had, at the beginning of the taxable year, written accounting procedures to expense for purposes of the AFS the amounts paid for property costing less than a certain dollar amount; (3) the taxpayer treated the amounts paid during the taxable year as an expense on its AFS in accordance with its written accounting procedures; and (4) the aggregate of amounts expensed under this provision did not distort the taxpayer’s income for the taxable year (the “no distortion requirement”). Because the no distortion requirement was amorphous, the old regulations provided a safe harbor: there would be no distortion if the aggregate of amounts expensed under this policy (*including* the amounts under \$100) did not exceed **the lesser of** (1) 0.1% of the taxpayer’s gross receipts for the tax year; or (2) 2% of the taxpayer’s total depreciation and amortization expense for the tax year as determined in the applicable financial statement (“AFS”). However, a taxpayer could still qualify to use a higher capitalization threshold if it were able to demonstrate compliance with the no distortion requirement even if the percentage thresholds were breached.

Under the new regulations, to qualify for a higher capitalization threshold elements (1), (2), and (3) above still apply. However, (4) was replaced with a bright line: the aggregate of such amounts expensed under this policy (*not including* the amounts under \$100) cannot exceed **the greater of** (1) 0.1% of the taxpayer’s gross receipts for the tax year as determined for federal income tax purposes; or (2) 2% of the taxpayer’s total depreciation and amortization expense for the tax year as determined in the AFS. If the percentage thresholds are breached, the taxpayer fails and must use a \$100 threshold like anyone else.

Certain Special Industry Guidance Unaffected.

The temporary regulations leave undisturbed certain industry-specific guidance previously issued by the IRS, including:

- Rev. Proc. 2001-4 (permitting deductions for certain heavy maintenance on aircraft airframe);
- Rev. Proc. 2002-12 (permitting taxpayers to treat smallwares as non-incidentals materials and supplies);

- Rev. Proc. 2002-28 (permitting qualifying small business taxpayers to treat certain inventoriable items in the same manner as non-incidental materials and supplies);
- Rev. Proc. 2007-48 (providing a safe harbor method of accounting to treat certain rotatable spare parts as depreciable assets); and
- Rev. Proc. 2011-28 (providing UOP rules for wireless network assets).

Replacement of a Major Component or Substantial Structural Part – 50% Threshold Standards Replaced with Facts and Circumstances Analysis.

The temporary regulations retain the general rule requiring capitalization of amounts paid to restore a unit of property (“UOP”), including amounts paid for the replacement of a major component or a substantial structural part of a UOP.

However, the temporary regulations revise the manner in which the capitalization rules are applied with respect to improvements to buildings and their structural components by requiring taxpayers to consider the effect of the expenditure on certain significant and specifically defined components of the building, rather than the building and its structural components as a whole. These separate components include: HVAC systems, plumbing systems, electrical systems, escalators, elevators, fire protection and alarm systems, security systems, gas distribution systems, and any other systems defined in published guidance.

The temporary regulations also replace the prior definition of “a replacement of a major component or substantial structural part” – i.e., the replacement of (a) a part or combination of parts of the UOP, the cost of which comprises 50% or more of the replacement cost of the UOP; or (b) a part or combination of parts of the UOP that comprise 50% or more of the physical structure of the UOP – with a facts and circumstances standard that includes consideration of the quantitative or qualitative significance of the part or combination of parts in relation to the UOP.

Replacement After Casualty.

The temporary regulations retain the casualty loss rule that requires taxpayers to capitalize costs of restoring a UOP for damage with respect to which the taxpayer had taken a basis adjustment as a result of a casualty loss deduction under section 165, or which relates to a casualty event described in section 165. The temporary regulations do, however, permit taxpayers to elect to forgo the casualty loss deduction and instead deduct the cost of the repair.

Leasehold Improvements.

The temporary regulations clarify the UOP rules with respect to leasehold improvements. In particular, the temporary regulations provide that amounts initially capitalized as a lessee improvement are treated as a cost of acquiring or producing a UOP and are treated as a UOP separate and apart from the leased property being improved. For example, if a store owner leases space from a landlord and then builds out the space, the lessee’s buildout cost is capitalized separately and does not have to be treated as an improvement to the landlord’s building. However, if the lessee spends additional money to better what it previously built, the additional cost is not again separated, but is capitalized as an improvement to the lessee’s buildout.

Accounting for Rotables and Spare Parts.

Rotable and temporary spare parts are included as materials and supplies under the temporary regulations. Taxpayers are provided with the following three methods for treating costs related to rotatable spare parts, and the taxpayer must choose one:

- 1) Deduct the cost of the rotatable or temporary spare parts when used or consumed (for example, when the part breaks down or is changed out);
- 2) Capitalize and depreciate the cost over the applicable recovery period of the machine to which the parts relate; or
- 3) Deduct the cost upon initial installation.

Taxpayers are required to use the elected method for all rotatable and temporary spare parts in the same trade or business.

Mass Asset Account Changes.

The temporary regulations expand the assets includible in each general asset account by eliminating the existing rule that limits assets within a general asset account to those that have the same asset class. Instead, under the temporary regulations, each general asset account can be comprised of assets that:

- Have the same applicable depreciation method;
- Have the same applicable recovery period;
- Have the same applicable convention; and
- Are placed in service by the taxpayer in the same taxable year.

Also, consistent with the expansion of the definition of disposition of MACRS property, the temporary regulations expand the definition of a disposition from a general asset account to include a retirement of a structural component of a building.

Repair vs. Betterment.

The temporary regulations retain the prior general rule that an amount paid results in a betterment if it ameliorates a material condition or material defect that existed prior to the acquisition of the property or arose during the production of the property; results in a material addition to the unit of property (including a physical enlargement, expansion, or extension); or results in a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output. The temporary regulations add a number of new examples to illustrate and clarify whether a betterment has occurred under particular facts and circumstances.

Certain Partial Dispositions Now Allowed.

The temporary regulations modify the disposition and depreciation rules to minimize the unfavorable result that occurs when an original part and any subsequent replacements of the same part are required to be capitalized and recovered simultaneously. Namely, the temporary regulations revise the definition of “disposition” so as to allow a taxpayer to treat the retirement of a structural component of a building as a disposition of property.

Thus, under the prior rules, a taxpayer would be required to capitalize the cost of replacing a roof, and was not allowed a retirement loss with respect to the roof that was removed. Instead, taxpayers were required to continue depreciating the old roof over the same recovery period as the building. Under the temporary regulations, however, taxpayers would be permitted to treat the retirement of the old roof as a disposition and recognize the attendant loss.

Routine Maintenance Safe Harbor.

The temporary regulations retain the safe harbor rule under which amounts paid to perform certain routine maintenance are deemed not to improve the UOP, and thus need not be capitalized. Routine maintenance is defined as recurring activities to a UOP that a taxpayer expects to perform as a result of the taxpayer’s use of the UOP to keep the UOP in its ordinarily efficient operating condition. Examples of routine maintenance activities include inspection, cleaning, and testing of a UOP, and the replacement of parts of the UOP with comparable and commercially available and reasonable replacement parts.

Notably, the temporary regulations exclude from the routine maintenance safe harbor a building or a structural component of a building – a significant modification to the rules in the prior proposed regulations.

If you have questions about any of these news items,
your client service team at Accuity can bring you the resources that you may need.
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