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Final Tangible Property Regulations: Their Impacts on Dealerships

Effective for tax years beginning **on or after January 1, 2014**, the final tangible property regulations mandate sweeping changes for amounts paid to acquire, produce, or improve tangible property. These complex regulations **will impact virtually all automotive dealerships** for the upcoming filing of calendar year 2014 income tax returns.

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OVERVIEW

These regulations come after years of taxpayer uncertainty as to whether expenditures are repairs (expensed in the current year) or capitalized improvements (depreciated over time). Now, under the new regulations the taxpayer is provided a general framework for distinguishing capital expenditures from deductible supply, repair and maintenance costs via the **B**etterment, **A**daptations, and/or **R**estorations ('**BAR**') standards. In addition, the regulations provide further clarity for the tax treatment of materials and supplies, rotable parts, and temporary spare parts.

WHAT DOES THIS MEAN FOR MY DEALERSHIP?

Perhaps the most significant effect these regulations will have on dealerships surround store image upgrades and large expenditure repairs (i.e. roof repairs). Historically, store image upgrades, treated under a conservative approach, would be capitalized and depreciated over 39 years. However, the regulations allow for a current period deduction for any expense that constitutes a refreshment and has no "betterment" to either the building structure and/or any building system. If historical store image upgrades, in fact, do not rise to a "betterment," the regulations allow for the remaining net book value (of the store image upgrade) to be deducted in the current year. Similarly, if a past roof repair was capitalized and, under the new framework it does not meet the definition of a capital expenditure, it too can qualify for a deduction in 2014.

The flip side to potential opportunity is potential risk. Since the regulations allow for the taxpayer to make favorable accounting method changes they also allow for the IRS to revisit prior repair expenses, apply the new framework, and determine if past repairs should have been capitalized vs. expensed. To add insult to injury, if a repair should have been capitalized, the IRS will disallow the deduction – not just a loss in one year, recaptured in a later year, but a complete loss of the deduction.

CHANGE OF ACCOUNTING METHODS IN 2014

On top of the potential risk is **unavoidable administrative burden**. All historical tax treatments of repairs, materials & supplies, and capital expenditures are deemed to be established accounting methods by the IRS. In order to adopt the new regulations (which are mandatory), the IRS asserts that **taxpayers will have to formally change their accounting methods** to demonstrate compliance with the regulations. A formal accounting method change involves additional computations and the filing of a special-purpose form (Form 3115) along with your 2014 tax return. The cumulative taxable income effect of adopting the regulations will be either deducted in full in the current year or includible in taxable income over the next four tax years.

HOW MANY???

There are up to 25 different accounting methods or elections that might need to be made. However, most dealerships should anticipate looking at **the three most common**:

1. **Formally adopting a method of accounting for treating materials and supplies on hand**. Since most businesses have some sort of materials and supplies, we expect this to be a very common method change this year. One of the changes in this area would allow every taxpayer to establish a capitalization threshold, which until now had not been authorized under tax law.
2. **Adopting the new "unit of property" capitalization regime.** Method changes in this area will be particularly important for real property owners, but will likely also apply to manufacturers, or any business that is a tenant in leased real property. This regime also provides for determining deductible repair costs, as well as introducing a new safe-harbor for repairs and maintenance in certain situations.
3. Related to the previous method change, **any taxpayer adopting the "unit of property" regime may be eligible to take partial dispositions of previously capitalized assets**. This could result in accelerating deductions into 2014, which is a welcome raft of good news in this sea of administrative complexity.

WHAT TO-DO BEFORE YEAR-END

Given the far-reaching effects of these regulations, we are recommending that all of our dealership clients perform the following before the end of 2014:

- Create or revise your written capitalization policy
- Analyze your depreciation schedules for capitalized building improvements, store image upgrades, and/or incorrect lives or methods
- Assess current policies for tracking repairs and maintenance expenses and consider revising to align with the final regulations

LET'S GET PLANNING

While potentially significant benefits and/or compliance risks exist with the rollout of these regulations, dealerships will need to consult with their tax advisor to determine how their unique facts and circumstances will affect their tax positions in 2014 and beyond.

For any questions or additional clarification, please contact your tax advisor or a member of the Perkins & Co Dealer Services team:

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