Executive Summary

THE NEW "TANGIBLES" REGULATIONS - IMPACT ON AUTO DEALERSHIPS

CAPITALIZABLE EXPENDITURES VS. DEDUCTIBLE EXPENSES … IMPROVEMENTS VS. REPAIRS

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- The new "Tangibles" Regulations include nine (9) sets of Regulations which clarify and expand the standards for proper capitalization of specific expenditures associated with tangible property. These Regulations relate to …
    - Materials and supplies … *[Reg. Sec. 1.162-3T]*
    - Repairs … *[Reg. Sec. 1.162-4T]*
    - Capital expenditures in general … *[Reg. Sec. 1.263(a)-1T]*
    - Amounts paid to ***acquire*** or produce tangible property … *[Reg. Sec. 1.263(a)-2T]*
    - Amounts paid to ***improve*** tangible property … *[Reg. Sec. 1.263(a)-3T]*
    - Capital expenditures made by either a lessee or a lessor on leased property … *[Reg. Sec. 1.167(a)-4T]*
    - General asset accounts and accounting … *[Reg. Sec. 1.168(i)-1T]*
    - Accounting for MACRS (Modified Accelerated Cost Recovery System) property … *[Reg. Sec. 1.168(i)-7T]*
    - Dispositions of MACRS property … *[Reg. Sec. 1.168(i)-8T]*.
- The new "Tangibles" Regulations, which affect ***all*** taxpayers, were issued on December 27, 2011.
    - Originally, these ***Proposed*** Regulations were stated to be effective January 1, 2012.
    - However, IRS Notice 2012-73 has announced a delay in the effective date of the Tangibles Regulations.
    - Taxpayers will not be required to apply the ***Final*** Regulation rules to years before 2014. This is because the Treasury anticipates finalizing the Regulations sometime during 2013.
    - However, taxpayers will be permitted (i.e., may elect) to apply the rules in the ***Temporary*** Regulations to their 2012 and/or 2013 tax years - i.e., to tax years starting on or after January 1, 2012 and before the applicability date of the ***Final*** Regulations.
    - The Notice says that the Treasury expects the ***Final*** Regulations will affect - and in certain cases, simplify - the implementation of (1) the *de minimis* rules, (2) the safe harbor rules for routine maintenance, and (3) the rules under Sec. 168 for dispositions of depreciable property.
- The Regulations emphasize the importance of making a proper determination based upon ***all of the facts and circumstances***. The IRS acknowledges the highly factual nature of determining whether expenditures are for capital improvements or for ordinary repairs and the difficulties encountered in applying these standards in actual practice.
- Practitioners and taxpayers should approach the interpretation of the new Regulations with the expectation that it may be very difficult to avoid capitalizing substantial amounts of expenditures unless there are unusually favorable (extenuating) "facts and circumstances" that override the detailed rules.
    - *Bottom line* … "facts and circumstances" determinations trump everything else.
    - The Regulations contain frequent references to the need to consider the rules of Section 263A along with the rules set forth in the Regulations.
- Because Regulations enunciate new standards and changes from pre-Regulation case law, the apparently more precise rules set forth are illuminated by numerous examples. These examples must be studied in an attempt to determine what the IRS actually will permit. In many instances, there is no indication as to which facts given in an example may be (more or less) essential to the conclusion that is stated.
- Practitioners will have to become not only familiar, but proficient, with the statistical sampling procedures and requirements set forth in Rev. Proc. 2011-42. This will be necessary because the IRS will not permit taxpayers to use judgment sampling in applying the rules in the new "Tangibles" Regulations.

- ***"Reg. -3T."*** The principles for determining whether activities and expenditures relating to buildings should be capitalized or expensed are found in the general rules for ***"improvements,"*** under Reg. Sec. 1.263(a)-3T.
  - In applying these Regulations, it is critical to determine what constitutes a ***unit of property***. For a building, the "unit of property" consists of the building ***and*** its structural components ***and*** building systems. All three elements are considered together and collectively as a single "unit of property."
  - This specific Regulation includes detailed (and, in many places, subjective) rules for determining whether the expenditures are incurred for (1) a *"betterment,"* (2) a *"restoration"* to the building, building structure and/or the building systems, or (3) an *"adaptation"* of the building (including the structure and/or any of the building systems) to a new or different use.
  - This Regulation is divided into seventeen (17) Subsections which are lettered (a) through (q) and includes eighty-eight (88) fairly detailed examples.
  - ***Automobile dealerships.*** An *Automotive Alert* issued by the IRS Motor Vehicle Technical Advisor (Feb. 2012) identified three examples as likely to be relating to the current dealership activity involving facility upgrades and improvements. These are *Examples #6*, *#7* and *#8*, which are included among the 19 examples under Reg. Sec. 1.263(a)-3T(h)(4).
    - These three examples are not specific to auto dealerships. Upon close analysis, these examples provide little helpful insight except to create the expectation that significant amounts usually will have to be capitalized when all of the facts and circumstances are taken into consideration.
- The new Regulations include important correlative revisions to the fixed asset tax accounting rules for depreciation and disposition when a replacement of a major component or substantial structural part of a building occurs.
  - This includes the revision (expansion) of the definition of a "disposition" … so that taxpayers may treat the retirements of structural components of buildings as "dispositions" of property.
  - This will allow taxpayers to recognize a loss on the disposition of a structural component of a building before the disposition of the entire building.
  - Accordingly, taxpayers will not have to continue to depreciate amounts allocable to structural components that are no longer in service. In other words, taxpayers will not be required to capitalize and depreciate simultaneously amounts paid for both the removed and the replacement properties.
- ***If a taxpayer elects to apply the rules in the Temporary Regulations to 2012, some of the elections to be made in 2012 income tax returns*** can be accomplished by simply reflecting the properly computed amounts in the tax return being filed. In other words, no affirmative election statements are required. In other instances, specific forms must be completed and included in the income tax return in order to make the election.
- ***Changes in accounting methods (CAMs).*** In conforming existing practices to comply with the new Regulations, taxpayers will be required to make changes in methods of accounting.
  - Revenue Procedures 2012-19 and 2012-20 provide specific guidance for making CAMs under the new T-Regs.
  - Most of these changes will be "automatic" and will involve the computation of Section 481(a) adjustments.
  - Under the limitations currently included in the Regulations, in many situations, it may be extremely difficult - if not impossible - to make proper computations of the required Sec. 481(a) adjustments because taxpayers may only use the results of computations derived from the application of the statistical sampling procedures that are sanctioned by Rev. Proc. 2011-42.
  - Unless the changes in accounting methods under consideration are relatively straight-forward and do not reflect practices that involve large dollar amounts over a lengthy span of years … taxpayers may prefer to wait until these new Regulations are finalized before they file Forms 3115 to make some of these changes.

- ***"Risk management" vs. ignoring the new Regulations.*** In interpreting the new Tangibles Regulations, many practitioners are of the opinion that … as a matter of proper "risk management" by a dealership/taxpayer … the adverse effect of reporting manufacturer payments for facility upgrades as income when received can be mitigated (to some extent) by complying with provisions in the new Tangibles Regulations.
  - However, practitioners should approach the interpretation of the new Tangibles Regulations with the expectation that it may be very difficult to avoid capitalizing substantial amounts of expenditures unless unusually favorable extenuating "facts and circumstances" override the detailed rules.
  - ***Schedule UTP (Uncertain Tax Positions) and other concerns.*** Failure to comply with the new Regulations to years after they become effective may constitute negligence and raise corresponding concerns over potential penalty assertions by the IRS.

Source: ***"The New Tangibles Regulations: Part III … Impact on Auto Dealerships"***
presented by Willard J. De Filipps, CPA for De Filipps University on October 16, 2012.
(with modifications to reflect subsequent issuance of IRS Notice 2012-73 on Nov. 20, 2012)