Miller & Chevalier

IRS Releases Transitional Guidance for "Repair Regulations" - Time for a Second Look at General Asset Accounts

Tax Alert

03.20.2012

On December 23, 2011, Treasury and the Internal Revenue Service ("IRS") issued temporary and proposed regulations governing the treatment of expenditures related to tangible property (the "Repair Regulations"). Recently, on March 7, 2012, the IRS released two revenue procedures, Rev. Proc. 2012-19 and Rev. Proc. 2012-20, outlining the procedures by which a taxpayer may obtain automatic consent to change its method of accounting to implement the Repair Regulations. Rev. Proc. 2012-19 focuses on automatic changes with respect to supplies costs, repairs and maintenance costs, capital expenditures, and costs to acquire, produce, or improve tangible property. Rev. Proc. 2012-20 addresses the disposition and depreciation of applicable assets. On March 15, 2012, the Large Business and International division of the IRS ("LB&I") issued a directive advising examining agents to take certain actions in response to the Repair Regulations and the Revenue Procedures.

In the aggregate, these various pronouncements encompass nearly 200 pages of relatively detailed, fairly complex, and often tedious rules governing a wide variety of practices in the area of capitalizations and deductions. In many cases, taxpayers, practitioners, and the IRS are still wrestling with how these rules apply, or should apply, to various facts and circumstances. The results remain uncertain on several of these issues. Also, due to the breadth of the regulations and procedures and the large number of options for which they provide, the rules apply in different ways to different taxpayers. In an effort to be timely, this alert identifies a number of initial issues that should be considered by all taxpayers. Additionally, this alert focuses specifically on general asset accounts ("GAA"), which, given the language contained in the Repair Regulations, has now become a significant issue that should be considered by all taxpayers.

Among items of common interest to most taxpayers are the following:

- The effect of the revenue procedures and LB&I Directive on repair issues now underway or anticipated for tax years beginning before January 1, 2012.
    - In general, the Rev. Procs. and the Directive should cause examining agents to cease current audit activities involving certain repair issues and not to begin new audits of these issues for years prior to 2012.
- The effect of the new regulations and procedures on previously agreed resolutions of repair issues, whether such resolutions are embodied in closing agreements or other documents covering pre-January 1, 2012, tax years.
    - Representatives at the IRS have indicated that prior resolutions and agreements should be given continuing effect, assuming that such agreements and resolutions are not inconsistent with the Repair Regulations and procedures.
- How to optimally combine the various transition approaches to compliance with the new rules. The approaches include section 481 adjustments, modified cutoff approaches, or full cutoff approaches.
    - Various method changes in the Rev. Procs. are subject to these types of adjustments or approaches.

- Whether to file a single 3115, split required method changes into separate Forms 3115 (with one or more filed in 2012 and others filed in 2013), or to defer all filings until 2013.
    - The Rev. Procs. do not prohibit the filing of multiple applications, but IRS officials have indicated that multiple 3115s may not be appropriate in all cases.
- The use of statistical sampling, representative sampling, and extrapolations to lessen compliance burdens.
    - The Rev. Procs. specifically approve statistical sampling in certain instances but do not mention, and thus do not appear to foreclose, the use of representative sampling or extrapolation of data from current years to prior years.

Each of these matters requires careful consideration of the particular facts, circumstances, and goals of each taxpayer.

One potentially underappreciated topic that should be evaluated by all taxpayers is the potential use of GAA elections. Although GAA elections have been relatively rare in the past, the new rules provide taxpayers with considerably more flexibility and security than have been available in the past and, surprisingly, make these elections potentially the more valuable of the available alternatives on a going forward basis. Given the retroactive applicability of these elections (as offered in Rev. Proc. 2012-20) and the potential for an early benefit from them, taxpayers should begin an evaluation of the Repair Regulations and procedures promptly.

General Asset Accounts

Under the new rules, taxpayers are given the greatest degree of flexibility through the use of GAAs. For instance, the use of the GAA system will no longer deny deductions otherwise available to taxpayers and in fact may prevent a loss of basis that could occur without a GAA election. Take for example a taxpayer that owns a building with elevators. The taxpayer disposes of an elevator and incurs costs associated with replacing the elevator.

Because of the rules relating to restorations, which preclude both a claimed loss on the replaced property and the deduction as a repair for the cost of the new elevator, the taxpayer cannot claim both a loss on the old elevator and a deduction for the new elevator. Under the Repair Regulations, in the absence of a GAA election, the taxpayer must claim a loss on the old elevator and capitalize the cost of the new elevator. Since the cost of the new elevator is likely to exceed the undepreciated basis of the old, this is not a favorable outcome. If the taxpayer sought to avoid this result by not claiming a loss on the old elevator, the result could either be a loss of basis for the deduction not claimed or, even worse, an assertion by the IRS that the forgone deduction should have been claimed, and the failure to claim it does not permit a repair deduction for the cost of the new elevator. Also, unless, the taxpayer can identify the basis of the old elevator to deduct the loss (assuming it wants to capitalize the cost of the new elevator), the IRS might in a future audit challenge the amount of the deduction taken for the tax basis of the replaced elevator.

However, if the taxpayer has made a GAA election with respect to the replaced elevator, the taxpayer has the option of claiming a loss for, or continuing to depreciate, the replaced elevator. This enables the taxpayer to achieve the better tax outcome without shouldering the risk of losing the remaining basis in the replaced elevator. At the same time, if the taxpayer seeks to deduct the cost of the new elevator, the GAA election would allow the taxpayer to continue to depreciate the cost of the old elevator.

The Repair Regulations allow taxpayers to make an election for those assets that it wishes to place in a GAA. Taxpayers may want to consider making such an election to take advantage of the added flexibility offered. GAAs, as opposed to single asset accounts or multiple asset accounts under Temp. Reg. § 1.168(i)-8T, allow taxpayers to continue to depreciate assets even after disposition (as opposed to the default rule in section 1.168(i)-8T requiring taxpayers to cease depreciation and recognize gain or loss).

A taxpayer that makes a GAA election may place assets that are subject to the election into one or more GAAs, each with one or more assets. Each GAA may only include assets that: (i) have the same applicable depreciation method; (ii) have the same applicable recovery period; (iii) have the same applicable convention; and (iv) are placed in service in the same taxable year. There are certain exceptions to the type of assets that may be grouped together (for example, assets that are subject to the mid-quarter convention may only be grouped into a GAA with assets that are placed in service in the same quarter of the taxable year).

Generally, unless the taxpayer elects otherwise, upon disposition of an asset in a GAA, no loss is recognized, and the taxpayer continues to depreciate the GAA, including the asset disposed of, as if no disposition occurred. In this regard, the Repair Regulations provide that a disposition includes the retirement of a structural component of a building. However, the Repair Regulations permit a taxpayer to make an optional election to terminate GAA treatment upon the disposition of all assets, or the last asset, in a GAA. In such case, the taxpayer would recognize the gain or loss of the disposition. Similarly, a taxpayer may also make an optional election to terminate GAA treatment upon a qualifying disposition, which is any disposition that does not involve all the assets, or the last asset, remaining in a GAA.[1] Upon such a disposition, the asset is removed from the GAA as of the first day of the taxable year in which the qualifying disposition occurs, and the taxpayer recognizes the gain or loss associated with the disposition.

Revenue Procedure 2012-20

Rev. Proc. 2012-20 addresses the procedures for a change in method of accounting related to GAAs. As noted in more detail below, taxpayers wishing to make these accounting method changes must do so before the taxpayer's first or second taxable year beginning on or after December 31, 2011. Although this two-year window gives taxpayers time to consider the issues, because of the complexity and the number of options available, taxpayers should move promptly in evaluating the affect and applicability of these rules and options.

The Revenue Procedure modifies Rev. Proc. 2011-14 by adding new section 6.32 regarding GAA elections. This section applies to taxpayers that want to make a GAA election under Treas. Reg. §§ 168(i)(4), and 1.168(i)-1, and Temp. Reg. § 1.168(i)-1T for one or more items of MACRS property placed in service before January 1, 2012, and for which a GAA election was not previously made. (This retroactive election is referred in the Repair Regulations as a "late election".) In other words, for those assets that were placed in service prior to the effective date of the Repair Regulations, the Revenue Procedure allows taxpayers to elect GAA treatment. By electing GAA treatment, taxpayers will be permitted to continue to depreciate assets following their retirement, or if the taxpayer so elects, to recognize gain or loss on such retirements. A taxpayer that fails to make the election within the two-year period beginning on or after January 1, 2012, risks losing the benefit of this choice for pre-2012 assets.

Section 6.32 also applies to those taxpayers who wish to make a late election to recognize gain or loss upon the disposition of all assets or the last asset in a GAA. Thus, once a GAA election is made, the Revenue Procedure confirms that the same flexibility provided in the Repair Regulations applies to previously capitalized and non-deducted amounts by allowing taxpayers to make an optional election to recognize gain or loss upon the requisite asset disposition (instead of continuing to depreciate the retired asset).

Similarly, the section applies to taxpayers who made a valid GAA election for an item of MACRS property and would like to make a so-called "late election" to recognize gain or loss upon the disposition of that item in a qualifying disposition. Consequently, a taxpayer that made a GAA account election in prior years but that did not recognize gain or loss upon the disposition of the property, may now recognize such gain or loss through this late election.

As noted above, these elections must be made before the taxpayer's first or second taxable year beginning on or after December 31, 2011. The IRS will treat making a late election within this time frame as a change in method of accounting. If the taxpayer makes a late election after this period, then, although many might regard such change as a change in method of accounting, the Revenue Procedure makes clear that the IRS will not view it as such.

The Revenue Procedure provides that if the taxpayer makes a late GAA election, such change is made using a Code section 481(a) adjustment. If, however, the taxpayer makes this change for one or more items of MACRS property owned by the taxpayer at the beginning of the year of change, then such change is made using a modified cut-off method under which the unadjusted depreciable basis and the depreciation reserve of the asset as of the beginning of the year of change are accounted for using the new method of accounting. To make this change, the GAA must include a beginning balance for both the unadjusted depreciable basis and the depreciation reserve.

If the taxpayer makes a late election to recognize gain or loss upon a qualifying disposition or the disposition of all assets or the last asset in a GAA, then such change is made with a Code section 481(a) adjustment.

For those taxpayers making a late GAA election, the Revenue Procedure requires the taxpayer to attach to its Form 3115 a statement with a description of the assets to which the change applies. The taxpayer must also provide a statement in which the taxpayer agrees to apply all of the GAA provisions to the assets that are the subject of the election and that (with certain exceptions), the election is irrevocable and will be binding on the taxpayer for computing taxable income in the year of change and for all subsequent taxable years with respect to the subject assets.

A taxpayer making a late election to recognize gain or loss upon a qualifying disposition must also attach a statement with a description of the assets. Those taxpayers making a late election to recognize gain or loss upon a disposition of all of the assets or the last asset in a GAA must attach a statement describing the GAA to which the change applies. Additional information is also required if the late elections relate to any asset that is public utility property under Code section 168(i)(9).

Depending on the specific change the taxpayer makes, the Revenue Procedure generally provides that the taxpayer file a single Form 3115 containing the Code section 481(a) adjustment for all such changes. The signed Form 3115 should be filed with the IRS office in Ogden, UT (rather than the IRS national office) no earlier than the first day of the year of change and no later than the date the taxpayer files the original Form 3115 with its federal income tax return or the year of change.

Conclusion

GAA accounts offer taxpayers flexibility in determining whether to continue to depreciate assets after they are disposed of or, instead, to recognize gain or loss upon such disposition. The recently-released Revenue Procedure provides this same flexibility to taxpayers who wish to elect GAA treatment for those assets placed in service prior to the effective date of the Repair Regulations. Taxpayers should consider their particular situations, including the effect of prior resolutions and agreements with the IRS regarding the treatment of repairs. These are complicated matters giving rise to numerous questions, but in many cases, if not most, a GAA election may provide the best result. More significantly, and as discussed above, the failure to make such an election may put taxpayers at risk of losing basis associated with disposed assets. As a result, it is imperative that taxpayers evaluate their specific circumstances in the context of both the Repair Regulations and the associated Revenue Procedures.

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[1] A qualifying disposition also excludes certain non-recognition transactions, certain transactions subject to like-kind exchanges or involuntary conversions, technical terminations of partnerships, and transactions with a principal purpose of achieving a tax benefit or result that would not be available absent an election under this section. *See* Temp. Reg. § 1.168(i)-1T(e)(3)(iv), (v), (vi), & (vii).

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