# Tangible Property Regulations and Tax Update for the Oil and Gas Industry

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## Tangible Property Regulations

- "Repair Regulations"
- Affect almost all taxpayers
- Govern capitalizing and deducting expenditures for:
  - Acquiring,
  - Maintaining,
  - Repairing, or
  - Replacing tangible property

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## Tangible Property Regulations

- Why the need for these major changes?
  - Code Sec. 162 – Costs deductible as repair expenses if incidental in nature, and neither materially add to the value of property nor appreciable prolong its useful life
  - Code Sec. 263 – Costs are capitalized if for permanent improvements or betterments that increase the value of property, restore its value or use, substantially prolong useful life, or adapt it to new or different use
  - Significant controversy between IRS and Taxpayers

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## Tangible Property Regulations

- Final regulations issued 9/13/13 (TD 9636 – 222 pages)
- Replace 2011 temporary regulations
- Generally effective 2014
- Additional proposed regulations on tangible property dispositions
- Guidance for adoption still to be released

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## Tangible Property Regulations

- What do you need to do to be ready?
  - Document accounting policies and procedures
  - Assess new rules and your business
  - Meet with your tax advisor and auditor
  - Evaluate timing of adoption
  - Familiar with items addressed in Regs
    - Materials and Supplies
    - Rotable and temporary spare parts
    - De Minimis Safe Harbor – Company Policy

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## Tangible Property Regulations

- Unit of Property (UoP)
  - Group of functionally interdependent components
  - Building and major systems are separate units of properties
- Materials and Supplies
  - Acquired to maintain, repair or improve UoP
  - Items expected to be consumed in >=12 months
  - Useful life of 12 months or less
  - Cost of $200 or less
  - Published IRS guidance as M&S

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## Tangible Property Regulations

- Material and Supply Rules (Reg 1.162-3)
  - Defines:
    - Non-incidental materials and supplies
    - Incidental materials and supplies
    - Use or consumption of rotable and temporary spare parts
  - Coordination with other provisions of IRC
    - Exceptions – Sec. 162 (trade or business expenses) and Sec. 212 (expenses for the production of income)

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## Tangible Property Regulations

- Materials and Supplies defined
  - tangible property that is used or consumed in the taxpayer's operations that is not inventory and:
    - Component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and are not acquired as part of any single unit of tangible property;
    - Consist of fuel, lubricants, water and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in taxpayer's operations;
    - Unit of property with economic useful life of 12 months or less, beginning when used/consumed in taxpayer's operations

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## Tangible Property Regulations

- Materials and Supplies defined (cont)
  - tangible property that is used or consumed in the taxpayer's operations that is not inventory and:
    - Unit of property that has an acquisition cost or production cost (as determined under IRC 263A) or $200 or less; **OR**
    - Identified in published IRS guidance as materials and supplies eligible for treatment under this section
  - M&S not used to improve tangible property are deductible when paid(or incurred) if they are incidental, or are deductible when consumed if they are nonincidental

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## Tangible Property Regulations

- Materials and Supplies
  - Non-incidental materials and supplies
    - Amounts paid to acquire or produce M&S are deductible in the taxable year in which the materials and supplies are first used or consumed in the taxpayer's operations
  - Incidental materials & supplies
    - Amounts paid to acquire or produce incidental M&S that are carried on hand and no record of consumption is kept or physical inventory at beginning or end of taxable year are not taken, are deductible in the taxable year items are paid for
  - Use or consumption of rotable and temporary spare parts
    - Considered used or consumed, and deductible in year in which taxpayer disposes of the parts

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## Tangible Property Regulations

- Rotable and Temporary Spare Parts defined:
  – Rotable – M&S (defined above) that are acquired for installation on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation
  – Temporary – M&S (defined above) used temporarily until a new or repaired part can be installed and then are removed and stored for later installation
  – Standby emergency spare parts

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## Tangible Property Regulations

- Rotable and Temporary Spare Parts Methods:
  – Deduct when disposed of
  – Capitalize and depreciation
  – Optional Method (not available for standby spare parts)

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## Tangible Property Regulations

- Rotable and Temporary Spare Parts:
  - Election to capitalize and depreciate
  - TP may elect to treat as a capital expenditure and depreciate the cost of any rotable, temporary, or emergency spare part
    - Any property for which this election is made shall not be treated as material or supply
    - Exceptions – cannot be intended for use as a component part of defined M&S (under $200, have economic useful life under 12 months, or identified in published guidance by IRS as M&S) or taxpayer uses optional method for accounting for rotable and temporary spare parts (later discussed)
    - Election made on timely filed Federal tax return

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## Tangible Property Regulations

- Rotable and Temporary Spare Parts:
  - Optional Method for rotable and temporary spare parts
    - Must use this method for all rtsp used in same trade or business in which this method is used for books and records
    - Initial Installation – taxpayer must deduct amount paid to acquire or produce the part in the year that the part is first install on a UoP
    - Removal from UoP – after removal from initial UoP (and subsequent), tp must include in gross income the FMV of the part, and include basis of part at FMV of part included in income
    - Repair and maintenance of part – must be included in basis (not currently deductible)
    - Reinstallation of part – must deduct costs paid to reinstall
    - Disposal of part – must deduct costs included in basis in taxable year the part is disposed by the taxpayer

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## Tangible Property Regulations

- De Minimis Safe Harbor
  - Limit depends on presence of "applicable financial statement" (AFS)
    - Financial Statement filed with SEC
    - Audited financial statement
    - Financial statement filed with federal or state government or agency, other than SEC or IRS
  - Limit
    - Same for financial and tax accounting purposes
    - $5,000 with AFS (up to) per invoice or per item
    - $500 if no AFS

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## Tangible Property Regulations

- De Minimis Safe Harbor – Mandatory Written Accounting Procedures
  - Specify expensing limit for
    - Property costing less than specified dollar amount, or
    - Property with useful life of 12 months or less
  - Must be followed for financial accounting purposes
  - Annual, irrevocable election (statement filed with tax return)
  - Must be in place before the end of 2013

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## Tangible Property Regulations

- Costs to Improve Tangible Property
  - General rule: CAPITALIZE
    - Direct costs of improvement
    - Indirect costs directly benefiting or incurred because of improvement
  - Improvement
    - Betterment
    - Restoration
    - Adaption
  - Regulations give many extensive examples

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## Tangible Property Regulations

- Costs to Improve Tangible Property
  - Small taxpayer safe harbor
    - Average annual gross receipts of $10 million or less
    - Building with basis of $1 million or less
    - Improvements less than smaller of $10,000 or 2% of basis of building
  - Routine maintenance safe harbor
    - Performed more than once during the life of the UoP
    - Building and systems: Performed more than once during first 10 years of life
    - Keep in ordinary and efficient operating condition

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## Tangible Property Regulations

- Election to Capitalize Repair and Maintenance Costs
  - Annual election, irrevocable
  - Book conformity and simplification
  - Analyze costs expensed on books

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## Tangible Property Regulations

**History**

- The Health Care and Education Reconciliation Act of 2010
  - Added the Net Investment Income Tax (NIIT) as Section 1411 of the Internal Revenue Code
    - Effective for taxable years beginning <u>after</u> December 31, <u>2012</u>
- On December 5, 2012, the Treasury Department and the IRS issued proposed regulations relating to the NIIT
- On November 26, 2013, the Treasury Department and the IRS issued final regulations and additional proposed regulations relating to the NIIT
  - 163 pages of preamble
  - 140 pages of regulations

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## Net Investment Income Tax

- All IRC provisions that apply for federal income tax purposes apply for NIIT purposes unless otherwise indicated
  - Income excluded for federal income tax purposes is also excluded for NIIT purposes
  - Deferral or disallowance provisions applicable for federal income tax purposes are also applicable for NIIT purposes
- The tax is computed on Form 8960 – Net Investment Income Tax
  - Draft form was released on August 7, 2013
  - Draft instruction were released on January 6, 2014

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## Net Investment Income Tax

- Only certain individuals, estates, and trusts are subject to the NIIT
- Corporations and partnerships are not subject to the NIIT
  - But partners and S corporation shareholders may be subject to tax on the partnership's/S corporation's NII

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## Net Investment Income Tax

- The NIIT is equal to 3.8% of the lesser of:
  - Net investment income, or
  - Modified adjusted gross income in excess of:
    - $200,000 for single individuals
    - $250,000 for married couples filing a joint return
    - $125,000 for married couples filing separate returns
      - The above amounts are not indexed for inflation

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## Net Investment Income Tax

- During 2013, A, and unmarried U.S. citizen, has modified adjusted gross income of $190,000, which includes $50,000 of net investment income. A has zero NIIT because the threshold amount for a single individual is $200,000.

- If during 2014, A has modified adjusted gross income of $220,000, which includes $50,000 of net investment income, then A has a NIIT of $760 [3.8% x $20,000 (the lesser of (i) $50,000 or (ii) the excess of $220,000 over $200,000)].

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## Net Investment Income Tax

Gross Investment Income is

1. Interest, dividends, annuities, royalties, and rents
   - Unless such income is derived in the ordinary course of a non-passive trade or business other than trading in financial instruments or commodities
2. Income from a trade or business that is a passive activity (within the meaning of Section 469)
3. Income from a trade or business of trading in financial instruments or commodities
4. Net gain from the disposition of property
   - Unless the property is used in a non-passive trade or business other than trading in financial instruments or commodities

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## Net Investment Income Tax

- Investment income does not include:
  - Wages
  - Unemployment compensation
  - Operating income from a business in which the taxpayer materially participates
    - Unless the business involves trading in financial instruments or commodities
  - Social Security benefits

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## Net Investment Income Tax

- Investment income does <u>not</u> include (cont.):
  - Alimony
  - Tax-exempt interest
  - Gain excluded under Sections 121, 1031, etc.
  - Self-employment income
  - Distributions from qualified retirement plans and IRAs
    - Including net unrealized appreciation on employer securities

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## Net Investment Income Tax

- NII includes gross income derived from <u>two</u> types of trades or businesses
  - Passive activities
  - Trading in financial instruments or commodities

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## Net Investment Income Tax

- Material participation by a limited partner
  - If a limited partner materially participates, his or her share of the partnership's trade or business income is not subject to NIIT
  - A limited partner's share of partnership income *may* not be subject to self-employment tax to the extent that such amounts are not attributable to guaranteed payments for services rendered to the partnership

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## Net Investment Income Tax

- General rule – a limited partner is not considered as materially participating in any activity in which he or she is a limited partner
- Three exceptions
  - The limited partner participates in the activity for more than 500 hours during the tax year
  - The limited partner materially participated in the activity for any five taxable years during the ten taxable years that immediately precede the tax year in question
  - The activity is a personal service activity and the limited partner materially participated in the activity for any three taxable years preceding the tax year in question

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## Net Investment Income Tax

- Material participation by an S corporation shareholder
  - If an S corporation shareholder materially participates, his or her share of the S corporation's trade or business income is not subject to NIIT
  - An S corporation shareholder's share of the S corporation's income *may* not be subject to self-employment tax
    - See Rev. Rul. 59-221
  - Reasonable compensation for services rendered is required (and this amount is subject to employment taxes)

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## Net Investment Income Tax

- Observations
  - We now have three separate tax systems
    - Regular income tax
    - Alternative Minimum Tax
    - NIIT
  - The NIIT borrows heavily from Section 469
    - Thus, one must understand Section 469 in order to understand the NIIT
  - The NIIT rules are extremely complex

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## Temporary Provisions Expiring in 2013

Partial List of Tax Extenders set to expire in 2013

- Individual Provisions
  - Deduction for state and local sales taxes
  - Above the line deduction for expenses for teachers
  - Deduction for mortgage insurance premiums deductible as qualified interest
  - Exclusion of discharge of principal residence indebtedness from gross income

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## Temporary Provisions Expiring in 2013

Partial List of Tax Extenders set to expire in 2013

- Business Provisions
  - Research and experimentation credit
  - Work opportunity credit
  - Increase in expensing to $500,000/$2,000,000 and expanded definition of Section 179 property
  - Bonus Depreciation
  - Reduction in S corporation recognition period for built in gains tax
  - 15 year straight line recovery for qualified leasehold, restaurant, and retail improvements

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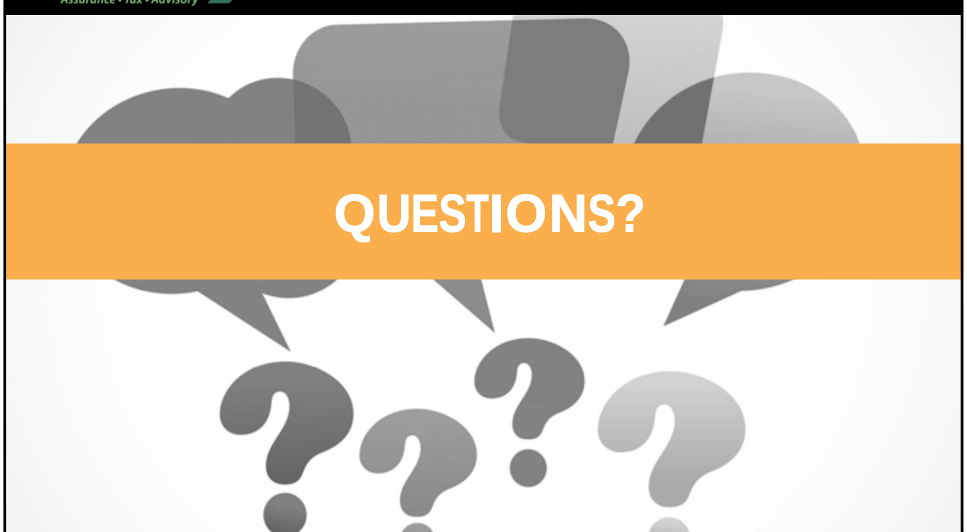


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