

Tax Alert

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Turning the science of business into an art.



Expenditures of Tangible Property Costs

By: Nicole Ackerman, Tax Senior - WeiserMazars LLP

In late December, 2011, the IRS released new temporary regulations that further discuss the deduction and capitalization of expenditures related to tangible property. These regulations clarify and expand the standards in current regulations under sections 162(a) and 263(a) and provide bright-line tests for applying these standards.

This is not the first time that the IRS has released guidance on these Regulations. In 2006, the IRS and the Treasury Department published proposed amendments to the regulations under Section 263(a). In 2008, the 2006 proposed regulations were withdrawn and replaced by a new set of proposed regulations. The 2008 proposed regulations provided many additional rules than were included in the prior 2006 proposed regulations. The new temporary regulations adopt and refine the 2008 proposed regulations as well as modify certain provisions and provide additional rules.

Under these temporary regulations, a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property, including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures, unless treated as materials and supplies as defined under the new temporary regulations or the de minimis rule applies.

General Rule

Currently, under Code Section 263, expenses are capitalized if they are for permanent improvements or betterments that increase the value of any property or estate, or substantially prolong its useful life. Costs are currently deductible as repair expense under Code Section 162 if they are ordinary and necessary expenses and neither materially add to the value of the property or prolong its useful life.

Materials and Supplies

Materials and supplies are currently deductible as expenses only in the amount actually used in operation during the year. Incidental materials and supplies purchased during the year are deductible in the year purchased if no record of their utilization is kept and there is no physical inventory taken. This method is only allowed if it clearly reflects income. Non-incidental materials and supplies are deductible in the tax year in which the materials and supplies are used or consumed in the taxpayer's operations. The timing rules for materials and supplies are generally the same under the temporary regulations.

The temporary regulations define "materials and supplies" as tangible property used or consumed in the taxpayer's business operations that is not inventory and that falls within the following categories:

1. A component acquired to maintain, repair or improve a unit of property owned, leased or serviced by the taxpayer, and that is not acquired as part of any single unit of tangible property
2. It consists of fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less
3. It is a unit of property with an economic useful life of 12 months or less
4. It is a unit of property with an acquisition cost or production cost of \$100 or less, or
5. It is identified as materials and supplies eligible for the rules in Regulation §1.162-3T

Unit of Property

The new regulations have provided a more workable standard for the definition of unit of property. A unit of

property is defined as a component that is functionally interdependent (one component's placement in service by the taxpayer is dependent on the placement in service of another component by the taxpayer). Temporary Regulation §1.263-3T(e) provides further guidance and detail on different types of property that are classified under this definition.

Amounts paid to acquire or produce a unit of real or personal property include the invoice price and all related transaction costs.

Rotable and Temporary Spare Parts

Rotable spare parts are materials and supplies acquired for installation on a unit of property. The spare parts can be removed from that unit of property, generally repaired or improved and either reinstalled on the same or other property. Temporary spare parts are materials and supplies that are used temporarily until new or repaired parts can be installed, and then are stored for later use.

Under the 2008 proposed regulations, a deduction is allowed for amounts paid for rotable and spare parts when the parts were discarded from the taxpayer's operations. As opposed to expensing the rotable or spare parts upon their disposal, a taxpayer may elect to capitalize the parts as separate property and depreciate the assets over their useful life.

There is a new alternative method for expenditures relating to rotable and temporary spare parts proposed in the temporary regulations. The costs of the spare parts can be deducted in the year that the part is first installed. When the part is removed from the unit of property, the taxpayer must include in gross income the part's FMV. The basis of the part should include its FMV when removed, the amount paid to remove the part from the unit of property, and amounts paid to maintain, repair, or improve the part in the tax year these amounts are paid. In the tax year the part is reinstalled, the taxpayer can deduct the amounts paid to reinstall the parts and all other amounts included in its basis, to the extent none of those amounts have been previously deducted. In the tax year the part is disposed of, deduct any additional amounts added to the basis that have not yet been deducted since reinstallation.

De Minimis Rule

The taxpayer can elect to apply the de minimis rule under Regulation § 1.263(a)-2T(g) to amounts paid for the acquisition or production of a unit of property, excluding inventory and land, if the following are met:

1. The taxpayer has an applicable financial statement (AFS)
2. There are written accounting procedures treating these amounts as an expense for property costing less than a certain dollar amount
3. The taxpayer treats the amounts paid during the taxable year as an expense on its AFS, and
4. The total aggregate of amounts paid and not capitalized for the taxable year are less than or equal to the greater of:
 - a. 0.1 percent of gross receipts for the taxable year, or
 - b. 2 percent of the taxpayer's total depreciation and amortization expenses for the taxable year as determined in the AFS.

The election to apply the de minimis rule is made on a timely filed return by deducting the amounts paid to acquire or produce unit of property in the tax year that the amounts are paid.

The taxpayer may also elect to capitalize the cost of the material or supply. This election is made by capitalizing the amount paid in the tax year it is purchased, by beginning to depreciate the cost of the material or supply. This election is also made on a timely filed return for the year that amounts are paid for these items.

The new temporary regulations allow the taxpayer to select which assets they will not elect to be subject to the de minimis rules. The portion of assets that are capitalized would reduce the threshold for the remaining portion of the assets that will have to satisfy the 0.1% and 2% limitations set forth above.

Compliance with Temporary Regulations

Under these temporary regulations, unless the de minimis rule applies or the asset is treated as materials and supplies as defined under the new temporary regulations, a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property.

The above rules generally apply in tax years beginning after December 31, 2011. A change to comply with these new regulations would require the taxpayer to change its method of accounting under the rules of Code Section 446 and Code Section 481, which requires the IRS's consent.

New Foreign Asset Reporting Requirement Effective for 2011 Individual Income Tax Returns

By: Jill Misener, Manager - WeiserMazars LLP

Beginning with the 2011 income tax return, individual calendar-year taxpayers will be required to report certain foreign accounts and assets on new IRS Form 8938, Statement of Specified Foreign Financial Assets, which is attached to the annual return. Entities become subject to the reporting requirements with the filing of 2012 returns. The new reporting requirements were created by the Foreign Account Tax Compliance Act (FATCA), enacted in 2010 as part of the HIRE Act (the Hiring Incentives to Restore Employment Act). The IRS recently issued temporary regulations providing guidance for individuals required to report specified foreign financial assets. The IRS has also released proposed regulations regarding filing by domestic entities.

The new financial asset reporting requirements under FATCA are in addition to any existing Foreign Bank Account Report (FBAR) filing requirements taxpayers may already have under the Bank Secrecy Act. Taxpayers may be required to file a Form 8938, an FBAR, or both, depending on the value of the foreign asset owned, the type of filer the taxpayer is, and the nature of the taxpayer's interest in the foreign asset. Failure to file Form 8938 could result in significant penalties, as well as an expanded statute of limitations period for the IRS to examine the taxpayer's return and assess additional tax.

Who is Required to File Form 8938

New tax code section 6038D requires certain U.S. taxpayers who hold an interest in a "specified foreign financial asset" in excess of \$50,000 during the taxable year to report information regarding those foreign assets on new IRS form 8938 that is attached to their annual income tax return.

Individuals

Individuals required to file Form 8938 include U.S. citizens, resident aliens and certain nonresident aliens who hold a "specified foreign financial asset" that exceeds prescribed thresholds, which are increased for taxpayers residing outside the United States.

"Specified foreign financial assets" include any financial account maintained by a foreign bank; stock issued by a non-U.S. person; interest in a foreign entity; and financial instruments or investment contracts with a foreign issuer. Taxpayers do not have to report financial accounts maintained by a U.S. domestic financial institution, the foreign branch of a U.S. financial institution, or the U.S. branch of a foreign financial institution. An interest in a

social security, social insurance or similar program of a foreign government is also excluded from the definition of foreign financial asset.

Individual calendar year taxpayers are required to start filing Form 8938 with their 2011 income tax return, which is filed in 2012. Individuals who otherwise are not required to file an income tax return are excepted from filing Form 8938.

Entities

Pursuant to the proposed regulations, “specified domestic entities” subject to the Form 8938 reporting requirement include certain domestic corporations, domestic partnerships and trusts, but exclude domestic estates. The proposed regulations regarding “specified domestic entities” apply to taxable years beginning in 2012. Accordingly, entities are not required to file Form 8938 with their 2011 returns.

Penalties for Failure to File

The minimum penalty for failure to file Form 8938 is \$10,000. Failure to file within 90 days after the IRS has notified the taxpayer of the failure subjects the taxpayer to an additional \$10,000 per month penalty, up to a maximum penalty of \$50,000. The penalty may be waived if the taxpayer can demonstrate that the failure to file was due to reasonable cause. If the IRS determines that a taxpayer who failed to file Form 8938 has an interest in a specified foreign financial asset, there is a presumption that the aggregate value of the foreign assets exceeds the filing threshold unless the taxpayer can demonstrate otherwise. FATCA also imposes a new 40% penalty on any portion of an underpayment attributable to a transaction involving an undisclosed foreign financial asset.

Statute of Limitations

The IRS generally has three years from the date a return is due (excluding extensions) or filed, whichever is later, to assess additional tax, or six years in the case of taxpayers with a substantial understatement of gross income. The extended six-year statute now also applies to taxpayers who omit more than \$5,000 of income attributable to assets required to be reported under section 6038D. Thus, even if the taxpayer does not have a substantial understatement, the IRS has six years rather than three to examine the taxpayer’s return and assess additional tax if the taxpayer has omitted \$5,000 or more of income attributable to reportable specified foreign financial assets.

If the taxpayer fails to file Form 8938, the return is considered incomplete and the statute of limitations may remain open for all or a part of the taxpayer’s return until three years after the date the Form 8938 is filed.

Form 8938 vs. FBAR

Filing of Form 8938 does not relieve taxpayers of the obligation to report foreign financial accounts on Form TD F 90-22.1 (FBAR). Certain foreign financial accounts are reported on both Form 8938 and the FBAR. However, the information required to be reported is different and, therefore, some taxpayers may be required to file either a Form 8938 or an FBAR but not both.

The FBAR has a lower filing threshold of \$10,000. Taxpayers are required to file an FBAR annually by June 30 if they have a financial interest or signature authority in a financial account during the preceding calendar year. For purposes of the FBAR, a taxpayer has a financial interest if they are the owner of record or hold legal title to an account. Signature authority exists if the taxpayer has authority to transfer assets held in an account. For purposes of Form 8938, an individual has an interest in a foreign account if transactions related to the account would be reportable on the individual’s tax return. The concept of “signature authority” does not apply to the Form 8938.

IRS Issues Final Regulations on Conduit Financing

By: Susan Grbic, Director - WeiserMazars LLP

On December 8, 2011, the IRS released T.D. 9562, finalizing amendments to Treasury regulation section 1.881-3 that apply to multiple-party financing arrangements that are effected through disregarded entities and that may potentially be recharacterized as conduit financing arrangements pursuant to section 7701(l) of the Code.

Section 7701(l) contemplates regulations to carry out its mandate of recharacterizing multiple-party financing transactions as a transaction directly among two or more such parties where the Treasury Secretary determines that such recharacterization is appropriate to prevent tax avoidance. By its terms, section 7701(l) extends to any and all multiple-party transactions, but the only substantial tax benefits that the regulations effectively curtail are the inappropriate application of: (1) an interest exemption (or reduced rate) under a treaty and (2) portfolio interest exemption.

Section 1.881-3(a)(2)(i)(C) of the final regulations provides that a disregarded entity that would not ordinarily be treated as separate from its sole owner is treated as a person under the regulation. As a result, in the context of a multiple-party financing arrangement, a disregarded entity will be taken into account in determining whether a "conduit financing arrangement" (defined as a financing arrangement that is effected through one or more conduit entities) exists. To the extent a person is characterized as a conduit entity, that person is excised from the transaction and the financing arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement for purposes of section 881.

The regulations are effective and apply to payments made on or after December 9, 2011. The preamble to the final regulations indicates that no inference should be drawn as to the treatment of financing transactions entered into with disregarded entities before the effective date of the final regulations.

Michigan Corporate Income Tax for 2012

By: Ozair Minty, Senior Manager - WeiserMazars LLP

Effective January 1, 2012 the State of Michigan replaced the Michigan Business Tax ("MBT") with the Michigan Corporate Income Tax ("CIT"). The MBT, which was in effect from 2008 through 2011 originally imposed a 4.95% business income tax and a 0.8% modified gross receipts tax. The MBT was imposed on all taxpayers including partnerships and corporations. The CIT, by contrast, is an income tax on corporations imposed at a rate of 6% after allocation and apportionment.

C corporations and entities taxed as C corporations for federal income tax purposes such as limited liability companies that check-the-box to be so taxed are subject to the CIT provided they have nexus with Michigan. Individuals and flow-through entities such as partnerships, S corporations and trusts are not subject to the CIT although these entities may be subject to withholding requirements if those entities are doing business in the state.

For CIT purposes a taxpayer has nexus with Michigan if it:

- Has physical presence in Michigan for more than 1 day during the tax year; or
- Actively solicits sales in Michigan and has Michigan gross receipts of \$350,000 or more; or
- Has an ownership or beneficial interest in a flow-through entity (directly or indirectly through one or more flow-through entities) that has nexus with Michigan.

For more information or questions on the CIT please contact the SALT practice group.

For more information, please contact your WeiserMazars partner or any member of our Tax Practice Board.

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