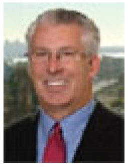

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Liberalized Tax Breaks for Taxpayers

How 2008 capital expenditures become a bit less taxing.

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Two significant changes in the way taxpayers report expenditures and depreciate fixed assets will be witnessed in taxable year 2008. The Treasury Department and the Internal Revenue Service have Proposed Regulations and adopted other statutory changes that clarify the treatment of expenditures and address the common concern of taxpayers, whether routine maintenance and repair costs can be deducted as a period cost (versus capitalized as a product cost).

The new Proposed Regulations intend to expand on areas in which the prior 2006 Proposed Regulations were vague with respect to the types of expenditures that can be expensed in the year they were incurred. Furthermore, as part of the Economic Stimulus Act of 2008, many smaller businesses will be able to benefit through two kinds of tax invectives: i) the bonus depreciation and ii) the increase of the Section 179 expense allowance.

Following is an overview of the significant updates that will offer taxpayers liberalized tax breaks for 2008 and beyond:

Repair and Maintenance Costs

A taxpayer is generally required to capitalize his or her costs of purchasing or producing fixed assets if the costs improve a unit of property.

The Proposed Regulations (Prop. Reg. Section 1.263(a)-3(d)(1)) provide three specific criteria for determining whether fixed asset costs should be expensed as repairs or capitalized. An expense must be capitalized if it results in any of the following:

- A betterment
- A restoration
- A new or different use

Even though the Proposed Regulations do not entirely change the general structure of the 2006 Proposed Regulations, they now apply general standards on how the above tests should be applied, as well as helpful “bright-line” tests, safe harbors and illustrative examples. In addition, the 2008

Proposed Regulations provide further guidance on determining the “unit of property” and identifying assets that should be accounted for as materials or supplies.

Unit of Property

A Unit of Property (Prop. Reg. Section 1.263(a)-3(d)(2)) is critical in analyzing whether the cumulative costs incurred must be capitalized or can be expensed during the current period. The Proposed Regulations generally treat all components that are functionally interdependent as a single unit of property. However, a building and its structural components are always treated as a single unit of property. Functionally interdependent machinery and equipment will not be treated as a single unit of property unless they are part of a group that performs a discrete and major function or operation.

A taxpayer who has assigned different economic useful lives to asset components for financial statement purposes or uses different depreciation method for the components, may not treat those components as a single unit of property. In addition, an improvement to a unit of property will not necessarily be considered a separate unit of property, even if it is separately depreciable.

In addition, the rules for “network assets” (i.e. railroad tracks, oil and gas pipelines, telephone and cable lines, etc.) remain the same as the 2006 Proposed Regulations. The Treasury and IRS believe that proper approach for these types of integrated assets should be determined on an industry-by-industry basis.

Materials and Supplies

The 2006 Proposed Regulations did not fully address rules for the tax treatment of “materials and supplies.” Under the current law, taxpayers may generally expense amounts related to tangible materials and supplies that are actually consumed or otherwise used within a taxable year. The problem with the previous Proposed Regulations was that it failed to identify assets with a useful life of 12 months or less as materials or supplies. The 2008 Proposed Regulations provide better guidance on how to distinguish fixed assets from supplies. Under the new Proposed Regulations, a material and supply is tangible property that is:

- Not a unit of property,
- A unit of property that has an economic useful life of 12 months or less, or
- A unit of property with a cost of $100 of less.

In addition, the new Proposed Regulations maintain the current position that the 12-month (useful life) period begins at the time the item is first used or consumed — and not before — even though the asset may be ready and available for use.

Transaction Costs

Current tax law provides rules for the capitalization of costs paid to acquire or produce property. However, a partial exception applies, allowing deduction for costs incurred during the period prior to making the decision to acquire a specific piece of depreciable real property. The rule poses potential problems since this exception is limited to only real property and is yet to provide guidance on how to allocate expenses incurred in acquiring assets other than real property. For example if a taxpayer incurs costs in evaluating the purchase of a group of assets including both real property, personal property, intangible assets and/or non-depreciable assets, such as land, there continues to be no clear statutory or regulatory guidance as to how the aggregate costs should be expensed vs. capitalized. There is, however, fact-specific case law which can be useful in evaluating the possible tax treatment — until further regulatory guidance is issued.

Repair Allowance Eliminated

The 2006 Proposed Regulations contained a proposal for a repair allowance which would allow maintenance expenditures to be deductible, up to a limit based on a percentage of the property's average basis. Theses rules did not contain any guidelines for specific industries. Any costs incurred in excess of the aforementioned maintenance expense calculation would then be capitalized as a new depreciable asset. The 2008 Proposed Regulations eliminates the Repair Allowance and provides authority to the IRS for issuing industry-specific repair allowance guidance at a future date.

Safe Harbors

The 2006 Proposed Regulations did not contain any "safe harbors" for *de minimis* costs and routine maintenance costs. With the 2008 Proposed Regulations, taxpayers have now been provided safe harbors for both.

***De Minimis* Costs**

A qualifying taxpayer will be allowed to apply a minimum capitalization threshold for acquiring or producing property. A qualifying taxpayer is a taxpayer that:

- Has applicable financial statements,
- Has a written accounting procedures for the expensing of *de minimis* items, and
- Recognizes *de minimis* costs as expenses on its financial statements.

An example would be a taxpayer who adopts a policy for both financial statements and tax purposes to expense any assets acquired that have a cost of less than $1,000.

A taxpayer will not be allowed to use this method to distort income. Under the new Proposed Regulations, *de minimis* standard will not distort income if the expensing policy does not exceed:

- 0.1 percent of a taxpayer's gross receipts, or
- 2 percent of the taxpayer's total depreciation and amortization on its financial statements.

Routine Maintenance

A new safe harbor allows a current deduction of routine maintenance activities that a taxpayer expects to perform more than once over the life of the asset to keep it in operational condition. A list of factors to consider when determining whether a maintenance cost should be deducted or capitalized include the recurring nature of the activity, the industry practice, the manufacturer recommendations, their personal experience, and how they will treat these costs on the financial statements. One exception to the safe harbor is that it does not apply in situations where the taxpayer has taken basis or loss in those assets (Prop. Reg. Section 1.263(a)-3(e)(2)).

Although the 2008 Proposed Regulations are still pending, it is likely that the Treasury and the IRS will issue the final regulations before the end of the 2008 calendar year.

Return of Bonus Depreciation
In addition to the new Proposed Regulation discussed above, taxpayers should also keep in mind the re-introduction of bonus depreciation and the extension and expansion of the Section 179 expensing rules for 2008 acquisitions.

Following is a summary of the tax incentives applicable to 2008 asset acquisitions:

The Economic Stimulus Act signed into law earlier this year temporarily reinstates bonus depreciation. Taxpayers will be able to depreciate an additional 50 percent of the cost of qualified property placed in service after Dec. 31, 2007 and before Jan.1, 2009. Only new equipment is eligible and taxpayers can choose to elect out of the bonus depreciation.

Bonus depreciation is allowed regardless of whether the taxpayer has positive taxable income or a net loss (unlike the Section 179 rules which limit the 179 write-off to the taxable income. Electing out of bonus depreciation treatment may still be preferable for a taxpayer in a net operating loss position (with no carryback eligibility), or where accelerated write-offs may negatively impact the taxpayer. Note that bonus depreciation is allowed for both regular and alternative minimum tax purposes and for the following types of property:

- Property to which MACRS applies that has an applicable recovery period of 20 years or less,
- Water utility property,
- Non-custom-made computer software, and
- Qualified leasehold improvement property (certain interior improvements to newer non-residential buildings).

To accommodate capital intensive businesses, for property with a recovery period of ten years or more and for certain transportation and aircraft equipment, the December 31, 2008 "placed-in-service" cut-off date is also extended an additional year.

Therefore, those taxpayers inclined to purchase a gas-guzzler this year may find some significant tax breaks to offset their future fuel bills. Note that both cash and accrual basis taxpayers can effectively accelerate the timing of vehicle acquisition costs by structuring the acquisition as a short-term "operating" lease, which will spread the write-off over the lease period or quicker for certain payments made by cash basis taxpayers.

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