The IRS and Treasury have issued long-awaited, comprehensive regulations on the capitalization of amounts paid to acquire, produce or improve tangible property. The regulations, released at the end of 2011 and effective immediately for most taxpayers, provide the standards that businesses must now apply to determine whether expenditures can be deducted as repairs or must be capitalized and then recovered over a period of years.

The regulations are broad and far-reaching – they apply to every business taxpayer that uses tangible property, whether owned or leased, regardless of the form of entity that operates the business, and regardless of the entity's foreign or domestic status. They apply to manufacturers, wholesalers, distributors, and retailers.

The new regulations have taken effect and steps must be taken to comply with them. They generally apply to amounts paid or incurred in tax years beginning on or after January 1, 2012. Thus, for calendar year taxpayers, the rules already apply. Some of the rules build upon rules already in place; other requirements, however, are completely new. The IRS will take comments and consider further changes, so any plans set forth to respond to these new regulations must themselves be ready for fine tuning.

The regulations are generally beneficial to most businesses, but they also add complexity. They provide a more defined framework for determining capital expenditures, along with some clarifications of the law and some simplifying conventions. The regulations make significant and substantial changes to the previous proposed regulations issued by the government in 2008. In many cases, the tax treatment of an expenditure will vary from its treatment for book purposes, putting an additional burden on taxpayers to apply new tax accounting systems to track and collect data.

The regulations will require many decisions by taxpayers in determining the appropriate tax treatment. In some cases, taxpayers are given an explicit election to decide what type of tax treatment to follow. In other cases, taxpayers must make a de facto election. In either case, once the taxpayer adopts a particular method of accounting for particular assets, that business must continue to follow that method of accounting, and will not be able to change it without the IRS's permission.

There will be more guidance from the IRS. Most taxpayers will need to change their method of accounting to comply with the new regulations. The IRS has promised to issue revenue procedures that provide transition rules for taxpayers changing their method of accounting. The regulations require that taxpayers make so-called Code Section 481(a) adjustments to prevent duplicated or omitted tax benefits. Because of this requirement, taxpayers will in effect have to apply the new rules to costs incurred prior to the effective date of the regulations. As a result, some taxpayers may have to capitalize amounts they previously deducted, and recognize income based on the difference in treatment. Conversely, other taxpayers may be able to deduct amounts previously capitalized, and take a deduction for the difference.

Our firm is here to help you determine how the regulations affect your business, what you must do to comply, what changes are necessary, what decisions must be made, and what opportunities are available. Please call or e-mail us so that we can arrange to discuss how this important development directly affects your business.