WHITE PAPER

POWERPLAN TAX REPAIRS

Practical Steps for Implementing the Tangible Property Regulations

POWERPLAN™

Introduction

Asset intensive companies are struggling with adopting the recent tangible property regulations and safe harbor guidance in a way that minimizes manual manipulation, eliminates system customization and provides necessary transparency. Any company anticipating large capital expenditures over time should leverage the tangible property regulations to deploy a robust tax strategy and optimize cash flow.

Historically, determining what is capital versus current expense for expenditures associated with tangible property has been a long-standing, contentious issue for both business taxpayers and the IRS. With the issuance of the final tangible property regulations and industry-specific safe harbor guidance, the expectation is that much of the contention will be replaced with more clarity instead of relying on the courts.

Now that regulations are finalized, the challenge shifts to how to implement the new rules. However it's not as easy as it appears. Why? In part, because the data necessary to automate the process is generally found in different systems or solutions. Adding to the complexity is the challenge of what the accounting, operations and IT groups need or are responsible for when it comes to expenditures. "Who would have ever known how many systems and processes a task like replacing a utility pole could touch? We spent a great deal of time just tracking through the spider web." – Tax Director – Regulated Utility

Despite the complexity and challenges, compliance with the regulations is required. This means businesses need to implement sustainable processes that are efficient, provide greater visibility and insight and are flexible enough to allow for future guidance or audit adjustments.

While meeting the compliance requirements taxpaying companies now have the opportunity to take advantage of the clearer definitions around the issue of capital versus repair to maximize the deduction and minimize the cash tax liability, resulting in annual savings anywhere from $10 million for smaller companies to more than $300 million for larger companies.

Companies who have successfully implemented the new tangible property tax rules have incorporated key stakeholders across the organizations in the discussion, developed a detailed implementation plan and modified business processes before incorporating the necessary changes. *"The key success to our automation project was getting all of the stakeholders on board early with the benefits to our company and our customers." – Tax Director*

This paper discusses the challenges of implementing the new regulations, the benefits of automating tax repairs and the critical steps needed to define your implementation process.

> **"Who knew all the integrated systems that are involved in the repair of a single power line?"**
> ~ Tax Director of Regulated Utility

I. History of Regulations and Other Guidance

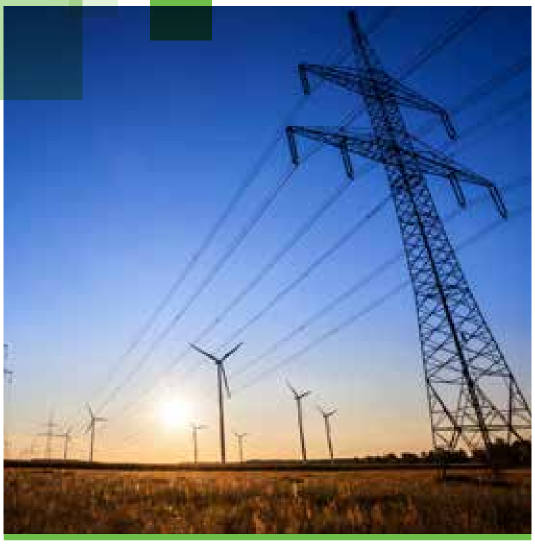
In 2006 the IRS issued the original regulations concerning the treatment of capital expenditures which were withdrawn in 2008 and reissued after receiving a not-so-welcome reception. Then in 2011, the IRS withdrew the 2008 regulations and issued new regulations in temporary and proposed form. Are you confused yet? Finally in September 2013, final regulations were issued with an effective date of January 1, 2014. The original regulations left a great deal of uncertainty and prompted various capital intensive industries to approach the IRS about issuing specific guidance. As a result the Industry Issue Resolution (IIR) program issued specific safe harbor guidance for:

1. Transmission and distribution network assets in the utilities industry (Rev. Procedure 2011-43)
2. Repair versus capitalization in the cable industry (Rev. Procedure 2011-27)
3. Power generation assets in the utilities industry (Rev. Proc. 2013-24)
4. Repair versus capitalization in the natural gas industry (Rev. Proc. 2014-17), and
5. Unit of property for network assets in the telecommunications industry (Rev. Proc. 2011-22, 2011-27 and 2011-28).

II. Key Challenges for Leveraging Tangible Property Regulations and Safe Harbor Guidance

The key challenge in implementing the tangible property regulations and leveraging tax repairs safe harbors is understanding the complexity of their application by industry. In order to follow the guidelines, the first hurdle is defining a "unit of property" for tax purposes. After defining the unit of property, companies must then determine if the work performed on that unit of property is a betterment, restoration, or adaption to a new or different use.

Inherent in defining a unit of property and then making determinations as to the result of the work performed is having the necessary data available. For instance, how are assets created for book purposes? Do the book accountants track assets at the level necessary for tax or for example do they consider everything at high, generic levels? In addition, the tangible property regulations interact with other book tax differences associated with self-constructed property particularly the UNICAP provisions. Avoiding "double counting" and reconciling these interactions is a must to ensure compliance and integrity of the deduction. Finally, manual or customized solutions to complete these tasks are time and resource intensive and make controls and reconciliations difficult at best.



III. Defining Unit of Property and Applying Standards within Specific Industries

Understanding how units of property are classified can be helpful in making accounting method determinations. For example, the unit of property differs by industry for track structures, wireline telecommunications, wireless telecommunications, electric power transmission, distribution and generation, and oil & gas distribution, midstream, transmission and downstream assets. The final regulations included the following examples:

a. Electric Power Transmission and Distribution Network Property

Defined broadly, electric transmission and distribution property includes "real and personal property that is used to conduct and control electricity at any point between an electrical generating station and the location of consumption of the electricity by the consumer," such as wires (conductors), towers, poles, structures and fittings mounted on towers and poles, electrical interrupters (such as circuit breakers, fuses and other switches), transformers, capacitors, instrumentation, security structures and pad on which equipment is mounted. It also includes street lighting and traffic and similar signal systems.

b. Generation property

Examples of generation property include coal-fired, natural gas-fired, oil-fired, hydroelectric, and nuclear-powered power stations. The safe harbor identifies the tax unit of property by the functional interdependence of how the plant operates. For example, a coal fired plant's boiler system is the tax unit of property but further broken down into a boiler's major components – steam drum, economizer, etc. The safe harbor does not include renewable energy such as wind or solar.

c. Oil & Gas Property

For midstream (pipeline transportation) the unit of property may be the section of pipeline between two compressor stations. When the Gas Distribution Industry Issue Resolution (IIR) is released, it is expected the non-linear unit of property definition will be more specific for compressor stations, processing plants, etc.

For downstream property (refineries and chemical plants) the tangible property regulations guidance on unit of property should be referenced. Some potential units of property are: the refinery or plant in its entirety, including crude distillation units, catalytic cracking units, hydrogen units, Amine treating and regeneration units, Dimersol units, and catalytic reforming units; chemicals created during the refining process; terminals and storage facilities.

We recommend consulting your tax professional as it relates to your specific circumstances.

IV. Automation is Key to Your Tax Strategy and In Maximizing the Benefits of the New Regulations

A company's tax strategy historically includes information, people, processes and technology. Information is key to your strategy and leveraging technology should enable the access of information and not be a barrier to success. Companies should not rely on manual systems, customizations or the infamous Excel spreadsheet to manage the process. By automating the repair regulations and eliminating these barriers, companies can achieve following objectives and benefits:

1. **Creating a Sustainable Process –** Allows you to synchronize your book asset records with your tax asset records and easily keep track of your additions, disposals and transfers. This provides the ability to support multiple books, users and companies.

2. **Enabling Compliance –** Enables the proper tracking of retirements and the proper ordering and management of all tax basis adjustments including 263a interest and overheads. The ability to incorporate and comply with future legislation is also facilitated through automation.

   a. **Meeting SOX and Other Audit Standards –** Helps ensure that the standards of completeness, validity, and accuracy are met and provides: 1) a system audit trail that tracks who made changes when, and 2) a financial audit trail with the ability to drill down to work orders and invoices to support calculations.

3. **Accommodating Business Changes –** Facilitates forecasting and budgeting efforts, allowing companies to quickly project cash flow considerations and provides data quickly and more reliably for estimated tax and tax planning purposes.

"When we began the process to implement the new regulations, automation and compliance were our key priorities."

~ Tax VP

4. **Maximizing Financial Benefit –** Enables the ability to assess large quantities of different projects by type to quickly apply multiple scenarios before choosing which scenario is best suited for your business. This also provides control of the overall process.

V. Taking Practical Steps to Implement the Regulations

With more clarity around the issue of capital vs repair for tax, best-in-class companies who automate their tangible property regulations can maximize the deductions and minimize that cash tax liability, resulting in annual savings anywhere from $10 million for smaller companies to more than $300 million for larger companies.

Once the barrier of interpreting and determining the appropriate application of the regulations and safe harbor by industry is overcome, the key to success is applying the new standards successfully and automating to maximize the benefits. Best-in-class companies who automate their tangible property regulations can achieve compliance, integrate their tax strategy and potentially maximize the deductions and minimize that cash tax liability, resulting in annual savings.

Here are steps to take to ensure that your adoption and automation goals are met:

1. **Assess Your Current State -** To determine where to start implementing your automated solution, ask these questions:
    - What methods and elections are currently in place?
    - What are your current book capitalization policies?
    - What will be the impact on other tax areas? (§263(a), §199, state income, earnings, etc.)

2. **Engage All Stakeholders –** The level of detail required for automation may impact your supply chain, enterprise asset management (EAM), operations and financial systems. Therefore, it is critical to engage other departments and functions across your business, for example, engineering, operations, accounting and IT, in order to document gaps and make plans.

3. **Determine Your Requirements –** Critical to the automation of tax repairs is developing a road map of information flow across your entire business in order to determine your ultimate requirements. Once you have your team assembled, define the requirements of each of your stakeholders and use these as the guidelines for decision-making as you identify changes needed for compliance and automation.

4. **Identify the Changes Needed for Compliance –** After you have defined the requirements of each of your stakeholders, take your previous review of your current accounting process and policies and identify the changes that need to be made for compliance. In addition, analyze the opportunities that exist for adopting new methods.

5. **Identify the Gaps in Automation –** Because there are so many departments and so many implications with tax repairs, build a design map to identify system gaps and areas of improvement needed to take full advantage of the tax repairs and be in compliance. For example, the questions you need to ask are:
   - What systems feed into your current ledger process?
   - Does your work management system allow for determination of categories of projects?
   - What planning tools are needed to run various scenarios?

6. **Put It All Together –** The final step in developing an implementation plan for your automated solution is developing roadmaps for your compliance and system changes and establishing checklists for actions needed to close automation gaps.

7. **Implement Your Plan –** Implementing a sustainable and automated solution requires a coordinated approach across the tax, accounting, and IT departments. The right partners and products will make your tax repairs automation implementation a success.

VI. Conclusion

With the final tangible property regulations in place, these new regulations present an opportunity to deploy a more advanced tax strategy, maximize current deductions and minimize cash tax liability for capital intensive businesses. Now companies can more easily classify an asset as a repair or capital improvement. However, to take advantage and save potentially millions in tax liabilities, you must eliminate manual assessments within your processes.

By automating the entire tax repairs process, companies save time and the team can focus on analyzing the data to make better business decisions, which ultimately helps maintain compliance and manage a significant deduction on the return. Creating a successful implementation plan for implementing the new tangible property regulations requires assessing the current state of your compliance processes, including stakeholders across the various businesses, and defining requirements for each. Once an implementation plan has been developed and successfully executed, tax departments will be quick to respond to the demands of CFOs and the marketplace with accurate and up-to-date cash flow analysis. A tax department with these regulations now automated will be able to interact strategically with overall strategies of the company.

About the Authors

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Jim brings more than 15 years of experience at PowerPlan in a wide variety roles including program management, product management, solution architecture and implementation. He was the key architect of the PowerPlan Tax Repairs, Project Management and Capital Budgeting Modules. He also designed and authored the Regulatory CWIP, Tax Repairs, Asset Retirement Obligation (FAS 143) and Reimbursable Projects modules.

Jim graduated with highest honors from the Georgia Institute of Technology where he received a Bachelor of Science degree in Industrial and Systems Engineering with a minor in Economics.

Tim Price - Director, Professional Services

Tim Price is an experienced consultant with extensive systems integration and management consulting experience. His expertise resides in the process design and implementation of accounting and work management applications. Prior to joining PowerPlan, Tim worked as a Manager at Accenture, in the finance and performance practice where alongside project work developed and documented best practice work management and finance POVs for the utilities industry.

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