Wolters Kluwer CCH

IRS Releases Comprehensive Repair/ Capitalization Final Regulations

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Special Report

HIGHLIGHTS

- New/Improved Safe Harbors
- Higher Materials/Supplies Threshold
- Expanded De Minimis Safe Harbor
- Special Rules For Small Businesses
- Routine Maintenance on Buildings
- Unit Of Property Rules
- January 1, 2014 Effective Date
- Optional 2012 Effective Date
- Impacts Estimated 4 Million Businesses

INSIDE

Final Regs Governing Repairs And Capitalization Make Significant Changes; Effective January 1, 2014

The IRS has released much-anticipated final "repair" regulations (T.D. 9636) governing when taxpayers must capitalize and when they can deduct their expenses for acquiring, maintaining, repairing and replacing tangible property. The final regulations make significant taxpayer-friendly changes to the 2011 temporary regulations. Compliance with the labyrinth of rules in the final regs, however, will challenge virtually every business, especially in light of an approaching January 1, 2014 effective date.

The basic structure and requirements within the temporary regulations remained intact. Although the final regulations have been "simplified" in several key areas, they remain complex overall.

IMPACT. *The final regulations are more taxpayer-favorable than the temporary regulations but, at over 200 pages, they still require a significant investment in time and talent to assure compliance. Every business with at least some fixed assets – that is, virtually every business –must comply with these new rules for its first tax year beginning on or after January 1, 2014. Some industries, such as retail, manufacturing, hospitality and utilities, are especially impacted. The difference between expensing and capitalizing can mean the difference between an immediate deduction at full value versus a deduction spread out over 5, 10, 15, 20 years or more.*

Delayed companion regs. In a surprise move, the IRS chose not to finalize companion regs governing general asset accounts and the disposition of depreciable property under Code Sec. 168. Instead, it issued proposed regs that make significant changes within this highly-controversial area. Nevertheless, the IRS reported that it aims to issue final regs with these changes by the end of 2013, with the same January 1, 2014 effective date as the final repair regs. Other portions of the temporary regs dealing with MACRS were finalized with little or no change.

IMPACT. *The Preamble to the final regulations estimates that approximately 4 million taxpayers will be impacted by the new regs, and that a combined 1.1 million hours of their time will be needed to address the new rules.*

Tight timetable for compliance. The final regulations must be followed by all taxpayers starting in tax years beginning on or after January 1, 2014; the final regulations – or the former temporary regulations— may (at a taxpayer's discretion) be followed retroactively back to the start of 2012. The IRS has promised critical "transition guidance" later this year to help taxpayers deal with implementation regarding how to apply the regulations for years prior to 2014 as well as what change-of-accounting procedures should be followed.

IMPACT. *As a result, some taxpayers would be wise to put certain procedures into place before the start of 2014 to maximize benefits; others should consider filing amended returns for 2012 and 2013 to take advantage of certain elections provided in the final regulations.*

Doing nothing is the least attractive option because taxpayers could discover that they are using impermissible procedures in their tax years beginning in 2014.

COMMENT. *In March 2013, the IRS issued an updated directive to examiners instructing them not to begin examining costs to maintain, replace or improve tangible property for tax years beginning on or after December 31, 2012 and before 2014. At that time, the IRS instructed its examiners to apply the regulations in effect and follow normal exam procedures and enforce the final regulations for examinations of tax years beginning on or after January 1, 2014. The IRS is expected to clarify its instructions to examiners now that final regulations have been issued.*

BACKGROUND

The IRS's stated goal in the final regulations is to reduce controversies with taxpayers by moving away from a facts and circumstances determination whenever possible, as well as from the subjective nature of the existing standards in general. Attempts to reduce controversy started with proposed amendments to regulations in 2006 (REG-168745-03, August 21, 2006), followed by new proposed regulations in 2008 (REG-168745-03, March 10, 2008) and temporary regulations (T.D. 9564) in December 2011. In 2012 the IRS moved the effective date of the 2011 temporary regulations from tax years beginning on or after January 1, 2012 to tax years beginning on or after January 1, 2014. Now, the temporary regulations have been modified and finalized. The final regulations carry an effective date of January 1, 2014, with taxpayers given the option to apply either the final or temporary regulations to tax years beginning after 2011 and before 2014.

IMPACT. *Practitioners have generally praised the IRS for taking many suggestions seriously, particularly including additional safe harbors and bright line tests in the final regulations. However, some are disappointed that other safe harbors/bright lines were not adopted and that the final regulations remain complex.*

NOTICE: *This CCH Tax Briefing highlights important changes that the final regulations have made to the 2011 temporary regulations. It does not attempt to review all of those provisions that the final regulations have carried forward from earlier versions. A grasp of those early, retained provisions nevertheless remains critical to full compliance. See CCH IntelliConnect for further details.*

> "The final regulations provide a general framework for distinguishing capital expenditures from supplies, repairs and maintenance."

OVERALL APPROACH

Code Sec. 263 requires the capitalization of amounts paid to acquire, produce, or improve tangible property. Code Sec. 162 allows the deduction of all ordinary and necessary business expenses, including the costs of certain supplies, repairs, and maintenance. The final regulations provide a general framework for distinguishing capital expenditures from deductible supply, repair and maintenance costs. They also cover accounting for the retirement of depreciable property under Code Sec. 167 and under Code Sec. 168's Modified Accelerated Cost Recovery System (MACRS).

Five Main Areas

The final regulations follow the basic outline of the proposed and temporary regulations, with changes made within each of five main areas:

- Materials and supplies (Reg. 1.162-3);
- Repairs and maintenance (Reg. 1.162-4)
- Capital expenditures (Reg. 1.263(a)-1);
- Amounts paid for the acquisition or production of tangible property (Reg. 1.263(a)-2); and
- Amounts paid for the improvement of tangible property (Reg. 1.263(a)-3).

Clarifications And Simplifications

Changes to the temporary regs were made to "clarify, simplify and refine," as well as to create several new safe harbors, according to the IRS. The changes singled out by the IRS in the Preamble include:

- A revised and simplified de minimis safe harbor under Reg. 1.263(a)-1(f);
- The extension of the safe harbor for routine maintenance to buildings;
- An annual election for buildings that cost $1 million or less to deduct up to $10,000 of maintenance costs or, if less, two percent of the building's adjusted basis;
- A new annual election to capitalize repair costs that are capitalized on a taxpayer's books and records; and
- The refinement of the criteria for defining betterments and restorations to tangible property.

IMPACT. *Many experts who have commented on the final regs agree that these five changes should be highlighted for their importance to taxpayers.*

The final regulations also tackle accounting for and retirement of depreciable property under Code Sec. 167 and accounting for MACRS property, other than general assets accounts or the definition of disposition for property subject to Code Sec. 168. The two latter issues are covered in a new set of revised proposed regulations "to address significant changes in this area."

MATERIALS AND SUPPLIES

The cost of non-incidental materials and supplies are generally deducted in the tax year first used or consumed.

The final and temporary regulations define "materials and supplies" to mean tangible

property used or consumed in the taxpayer's business operations that is not inventory and that is:

- A component that is acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer, but is not acquired as part of any single unit of tangible property;
- Fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in a taxpayer's operations;
- A unit of property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;
- A unit of property with an acquisition or production cost less than $100 under the temporary regulations and $200 under the final regulations; or
- Identified by the IRS in published guidance.

IMPACT. *Listening to critics, the IRS expanded the definition of materials and supplies that may be expensed to include property with an acquisition or production cost of up to $200, increased from an original $100 limit set under the temporary regs. The IRS reasoned that this higher threshold amount will "capture many common supplies such as calculators and coffee makers." The IRS rejected a call for a $500 threshold as too high, but retained language from the temporary regulations that would permit the IRS the flexibility to change the amount in the future without going through the cumbersome steps to actually amend the regulation.*

Spare Parts

The final regulations retain the general rule that rotable and temporary spare parts are materials and supplies that are deducted in the year used or consumed unless the taxpayer elects an optional method of accounting for the parts.

However, the final regulations add "standby emergency parts" to the definition of a material or supply that is deducted in the year used or consumed. The optional accounting method does not apply to standby emergency parts.

A rotable spare part is a material or supply which is installed on a unit of property, removed from the property, repaired or improved, and either reinstalled on the same or other property or stored for later installation. Temporary spare parts are components used temporarily until a new or repaired part can be installed and then are removed and stored for later installation. Standby emergency spare parts are parts acquired for a particular machine and set aside to avoid substantial operational time loss. Standby spare parts are usually expensive, and they are not subject to periodic replacement, acquired in quantity, repaired or reused.

Under the final regulations, only rotable, temporary or standby emergency spare parts qualify for the election to capitalize and depreciate as a separate asset amounts paid for materials and supplies used to repair or improve a unit of property. Without this limitation, different recovery periods could apply to a capitalized material or supply and the property it improves or repairs. The limitation is also consistent with previous IRS rulings.

COMMENT. *The procedure to revoke an election to capitalize and depreciate materials and supplies is also clarified. The taxpayer must file a request for a private letter ruling to obtain IRS consent, which the IRS may grant if the taxpayer acted reasonably and in good faith and the revocation will not prejudice the government. The IRS can modify these procedures through published guidance.*

COMMENT. *The IRS rejected a recommendation to expand the definition of rotable and temporary spare parts to include rotable spare parts that the taxpayer leases to customers in the ordinary course of a leasing business. The IRS concluded that such parts are outside the scope of regulations governing materials and supplies. The pro-taxpayer definition of standby emergency spare parts provided in Rev. Rul. 81-185, however, is adopted into the definition of materials and supplies eligible for the optional capitalization election under Reg. §1.162-3(d).*

Consistency with book treatment. Recognizing that taxpayers may have pools of rotable or temporary parts that are treated differently for financial statement purposes, the final regulations remove the requirement that an electing taxpayer use the optional method for all pools used in the same trade or business. However, if a taxpayer chooses to use the optional method for a pool for tax purposes, but does not use the optional method for that pool in its books and records for the trade or business, the taxpayer must use the optional method for all of its pools in that trade or business.

The IRS declined to make the optional method the default method as it would create an overly burdensome recordkeeping requirement for many taxpayers.

Safe harbor coordination. The final regulations seek to better coordinate the application of the de minimis rule applicable to materials and supplies under Code Sec. 162 and the general de minimis rule under Code Sec. 263.

Materials And Supplies Identified In Other Published Guidance

The IRS clarified that prior published guidance that permits certain property to be treated as materials and supplies remains in effect, including smallwares or certain inventoriable items used by small businesses.

ROUTINE MAINTENANCE

The temporary regulations provide that the cost of certain routine maintenance need not be capitalized. Under a routine maintenance safe harbor, an amount paid is deductible if it is for recurring activities that a taxpayer expects to perform to keep a unit of property in its ordinarily efficient operating condition. The activities

are routine only if, at the time the unit of property is placed in service, the taxpayer reasonably expects to perform the activities more than once during the class life of the unit of property.

Class life is the same as the MACRS alternative depreciation system (ADS) recovery period. Generally, this is longer than the regular MACRS recovery period.

Buildings Now Included

The final regulations expand the routine maintenance safe harbor to allow expensing for routine maintenance activities on a building and its structural components (including building "systems"). However, an activity is covered only if the taxpayer reasonably expects to perform such maintenance more than once over a 10-year period.

IMPACT. *The 10-year period may disqualify many maintenance items, especially for "smart" buildings and other "low- or no-maintenance" structures. However, the IRS assured taxpayers that it would not apply hindsight in determining whether the taxpayer properly anticipated maintenance more than once over a ten-year period. Thus, so long as the taxpayer reasonably expected to perform the maintenance at least twice in the ten-year period, the safe harbor applies even if the maintenance occurs only once.*

COMMENT. *The IRS reasoned that the inclusion of a routine maintenance safe harbor for buildings should alleviate some of the difficulties that could arise in applying the improvement standards for restorations to building structures and building systems.*

In determining whether maintenance is routine, the final regulations no longer consider the taxpayer's treatment of the costs on its financial statements. The factor was removed because taxpayers may have different reasons for capitalizing maintenance activities on financial statements so that the treatment is not particularly indicative of whether the activities are routine.

Under the final regulations, the routine maintenance safe harbor does not apply to amounts paid for repairs, for maintenance, and for improvements to network assets such as railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines. Network assets were excluded from the safe harbor because of the difficulty in defining the unit of property and the IRS preference for resolving network asset issues through the Industry Issue Resolution (IIR) program.

NEW ELECTION TO CAPITALIZE REPAIR AND MAINTENANCE COSTS

The final regulations allow taxpayers to make an annual election to opt out of expensing repair and maintenance costs if the taxpayer treats the costs as capital expenditures on its books and records. A taxpayer must elect to capitalize these expenses on its return. An electing taxpayer must also depreciate the expenditures.

CAUTION. *The preamble to the final regulations provides that this annual election may not be revoked. The new election allows a taxpayer to treat amounts paid during the tax year for the repair and maintenance of tangible property as amounts paid to improve that property and as an asset subject to the allowance for depreciation. The election applies only to amounts that the taxpayer incurs in carrying on a trade or business and treats as capital expenditures on its books and records used for regularly computing income.*

The election applies to all amounts paid for repair and maintenance to tangible property that the taxpayer treats as capital expenditures on its books and records for the tax year. An electing taxpayer must begin to depreciate the cost of such improvements when they are placed in service by the taxpayer under the applicable provisions of the Tax Code and regulations. The election is made by attaching a statement to the taxpayer's timely filed original tax return (including extensions) for the tax year in which the repair and maintenance expenditures are paid. The election may not be made by filing an application for a change in method of accounting or, unless permission to file a late election is first obtained, on an amended return.

IMPACT. *This election allows a taxpayer to align its tax treatment with capitalization policies used for its books and records, thus eliminating book-to-tax differences and reducing administrative costs. Taxpayers making this election also can avoid the application of difficult and often subjective rules in determining whether a particular expenditure is currently deductible as a repair or must be capitalized.*

The election does not apply to amounts paid for repairs or maintenance of rotable or temporary spare parts that are subject to the elective optional method of accounting for them.

In the case of a partnership or S corporation, the election is made by the partnership or S corporation and not by the partner or shareholder.

Unlike certain other elections in the final regulations, there is no option to file an amended 2012 or 2013 return to make this election.

DE MINIMIS SAFE HARBOR TO ACQUIRE OR PRODUCE

A taxpayer is generally required to capitalize amounts paid to acquire or produce a unit of real or personal property. The IRS provided a de minimis exception in the temporary regulations and enhanced it in the final regulations.

Temporary Regs

The de minimis exception in the temporary regulations allowed the deduction of amounts (up to a specified ceiling) paid for the acquisition or production of a unit of tangible property if the taxpayer had an applicable financial statement, had written accounting procedures for expensing amounts paid for property that did not exceed specified dollar amounts, and treated those

amounts as expenses on its applicable financial statement. Under an aggregate ceiling, a deduction allowed by the de minimis exception could not exceed the greater of:

(1) 0.1 percent of the taxpayer's gross receipts for the tax year as determined for federal income tax purposes, or
(2) two percent of the taxpayer's total depreciation and amortization expense for the tax year as determined on the taxpayer's applicable financial statement.

Final Regs

The final regulations remove the aggregate ceiling to the de minimis rule and replace it with a more manageable per-item or per-invoice limit. A taxpayer with an applicable financial statement may deduct up to $5,000 of the cost of an item of property per invoice (or per item as substantiated by an invoice). The required written accounting procedures in effect as of the beginning of the tax year may specify a per item amount of less than $5,000. As noted below, the final regulations allow taxpayers without an applicable financial statement to elect the de minimis safe harbor and expense up to $500 per invoice/item.

IMPACT. *The de minimis rule had been hailed as one of the most important provisions of the temporary regulations. Previously, expensing policies were not governed by any specific rules or requirements other than that the policy could not materially distort income. The aggregate ceiling in the temporary regulations was a step toward providing a bright-line standard, but the final regulations improve on this by eliminating the overall ceiling in favor of a per item or per invoice limit. The final regulations also extend the de minimis exception to taxpayers that do not have applicable financial statements, albeit at a lower per invoice/item limit ($500 instead of $5,000, as discussed in more detail below).*

COMMENT. *When accounting procedures expense items that exceed the $5,000 limit, it may still make the case with its IRS exam team that a greater amount is reasonable under its facts and circumstances. The IRS reminded taxpayers that the $5,000 limit is a safe harbor, rather than an absolute limit.*

IMPACT. *To take advantage of the $5,000 de minimis rule, taxpayers must have written book policies in place at the start of the tax year that specify a per-item dollar amount (up to $5,000) that will be expensed for financial accounting purposes. Calendar-year taxpayers, therefore, should work on having a policy in place by year-end 2013 to qualify for 2014. Although many taxpayers did not have written expensing policies in effect at the beginning of their 2012 tax year (the temporary regulations were issued in December 2011), the IRS declined to grant transitional relief for taxpayers who would otherwise have been able to apply the de minimis rule under the temporary regulations to their 2012 tax year.*

> "Changes to the temporary regs were made to 'clarify, simplify, and refine,' as well as to create several new safe harbors, according to the IRS."

De minimis safe harbor is elective. Under the temporary regulations, the de minimis rule appeared to apply to all qualifying expenses, unless the taxpayer "elected" not to apply the rule to a particular expense by capitalizing it. The final regulations provide that the de minimis rule is a safe harbor that is elected annually by including a statement with the taxpayer's tax return for the year elected. The election applies to all qualifying expenses, including materials and supplies that meet the requirements for qualification; an electing taxpayer cannot exclude particular qualifying expenses. An election to use the safe harbor may not be made through the filing of an application for change in accounting method. A late election may be made on an amended return only with IRS consent. The election is irrevocable.

COMMENT: *A transitional rule allows taxpayers to apply the de minimis rule contained in the final regulations to a tax year beginning in 2012 or 2013 by filing an amended Federal tax return. This relief is also provided for certain other provisions that require an election.*

COMMENT. *Regardless of whether or not the taxpayer has an applicable financial statement, the de minimis safe harbor does not preclude a taxpayer from reaching an agreement with the IRS that certain items will not be reviewed. Examining agents do not need to revise their materiality thresholds in accordance with the safe harbor limitations.*

Useful life of 12 months or less. The final regulations also expand the safe harbor to include amounts paid for property with an economic useful life of 12 months or less if the taxpayer's accounting procedures in place at the beginning of the tax year provide for the current deduction of such amounts. The cost of each item of short-lived property that is deductible under this de minimis rule may not exceed $5,000 ($500 for taxpayers without an applicable financial statement). The taxpayer's accounting procedures do not need to put a dollar cap on the cost of an item of short-lived property that it expenses under its accounting procedures. For example, if the taxpayer's accounting procedures expense all assets with a useful life of 12 months or less, the de minimis safe harbor applies to all such amounts unless the property costs more than $5,000 per invoice/item (or more than $500 if the taxpayer does not have an applicable financial statement).

Materials and supplies. In one of the few provisions in the final regulations

that is more restrictive to taxpayers, the final regulations require that an electing taxpayer must apply the de minimis safe harbor to all amounts, including eligible materials and supplies. The IRS argued that doing so simplifies the application of the de minimis rule and reduces its administrative burden.

The temporary regulations allowed a taxpayer that elected the de minimis safe harbor to apply it only to selected materials and supplies. Thus, the taxpayer could either deduct materials and supplies when used or consumed, or make the de minimis election and deduct their cost when paid, assuming the costs otherwise qualified for deduction under the de minimis rule.

Taxpayers Without Applicable Financial Statements

In a concession principally to smaller businesses, the final regulations add a safe harbor for taxpayers without an applicable financial statement. The per-item or invoice threshold amount in that case is $500. The IRS argued that it was justified in imposing that lower threshold since there would be less assurance that the accounting procedures clearly reflect income. The $500 limit (like the $5,000 ceiling for taxpayers with applicable financial statements) is all or nothing; if the cost of an invoice or item exceeds the applicable limit, then no portion of the cost is deductible under the safe harbor.

Special Rules For Determining Invoice Price

The final regulations provide an anti-abuse rule that prohibits taxpayers from "manipulating a transaction" to avoid the $5,000 or $500 per item limit. The rule specifically prohibits "componentization" of an item of property. For example, a taxpayer who purchases a truck cannot split the cost of the truck into three components (such as the engine, cab and chassis) on three invoices in order to avoid the dollar limit.

The final regulations also clarify the treatment of transaction costs and certain other additional costs paid in connection with the acquisition of property for purposes of the $5,000/$500 per item limit.

A taxpayer must include all additional costs, such as delivery fees, installation services, and similar costs that are included on the same invoice as the invoice for the cost of the property. If these additional costs are not included on the same invoice as the property the taxpayer may, but is not required to, include the additional costs in the item of property.

COMMENT: *The inclusion of additional costs by the vendor in the same invoice as the property item could unnecessarily cause the cost of the property item to exceed the $5,000 or $500 limit. The taxpayer should arrange in advance for separate invoices for the property item and additional costs if possible in such a situation. It does not appear that this strategy would violate the anti-abuse rule. An example included in the final regulations allows a taxpayer to include separately-invoiced related costs in the de minimis election.*

When multiple items of property are purchased on one invoice and additional costs are stated as a lump-sum, the taxpayer must use a reasonable method to allocate the additional costs among each item of property when computing the per item cost.

IMPROVEMENTS

The final regulations continue to require capitalization of amounts paid to improve a unit of tangible property. A unit of property is improved if amounts are paid for activities performed by the taxpayer resulting in:

- A betterment to the unit of property;
- A restoration of the unit of property; or
- Adaptation of the unit of property to a new or different use.

COMMENT. *A unit of property for this purpose consists of a group of functionally interdependent components, such as the parts of a machine, with the machine being treated as a unit of property. In the case of a building, the building (including its structural components) is a unit of property. However, certain major systems of the building, such as heating, air conditioning, and ventilation (HVAC), plumbing, and electrical, are treated as separate units of property for purposes of determining whether there has been a capitalizable betterment, restoration, or adaption to the system.*

The final regulations retain the unit of property rules in the temporary regs. For real property, the regs continue to apply the rules to both the building structure and to specified building systems. They also keep certain simplifying conventions, including a routine maintenance safe harbor and the optional regulatory accounting method.

IMPACT. *The IRS explained that application of the improvement rules to both the building structure and the defined building systems is necessary to help ensure that the improvement standards are applied equitably and consistently across building property.*

IMPACT. *The IRS does recognize that some taxpayers may have "particular facts and circumstances of a subset of buildings used in one or more industries" that present unique challenges to application of the building structure or building system definitions. For them, the IRS suggested that they request guidance under the Industry Issue Resolution (IIR) procedures.*

Removal costs. The final regulations clarify that the cost of removing a depreciable asset or a component of a depreciable asset is not capitalized as an improvement if the taxpayer realizes gain or loss on the removed asset or component. If a taxpayer disposes of a component of a unit of property and the disposal is not a disposition on which gain or loss is realized, then the taxpayer deducts the costs of removing the component

if the removal costs directly benefit or are incurred by reason of a repair to the unit of property. Otherwise the removal costs are capitalized as part of the improvement costs to the unit of property.

IMPACT: *Under proposed MACRS disposition regulations that were issued in conjunction with the final repair regulations, a taxpayer may recognize a loss on the retirement of a component of an asset, such as a structural component of a building, if the taxpayer makes an election to treat the retirement as a partial disposition of an asset and recognize the loss. This election should be exercised with caution because the final regulations retain the rule in the temporary regulations which requires the capitalization of any costs related to a repair as a restoration if a loss deduction is claimed. Under the temporary MACRS regulations, which are optionally effective for tax years beginning on or after January 1, 2012 and before January 1, 2014, loss recognition on the retirement of a structural component is mandatory unless the taxpayer places the building in a general asset account.*

Safe Harbor For Small Taxpayers With Buildings

Small taxpayers complained that they could not afford to collect and maintain the documentation necessary to apply the improvement rules in the final regulations to their buildings. In response, the final regulations include an annual safe harbor election for buildings owned or leased by a taxpayer with an unadjusted basis (i.e., generally cost) no greater than $1 million.

The taxpayer must have average annual gross receipts of $10 million or less during the three preceding tax years. Gross receipts are specially defined and include income from sales (unreduced by cost of goods), services, and investments.

In the case of a lessee, the unadjusted basis of the building is equal to the total amount of (undiscounted) rent paid or expected to be paid over the entire lease term, including expected renewal periods.

Under the new exception, the small taxpayer is not required to capitalize improvements if the total amount paid for repairs, maintenance, improvements and similar activities during the year that are performed on the building does not exceed the lesser of $10,000 or two percent of the unadjusted basis of the building. Amounts deducted under the de minimis rule or the new safe harbor for routine maintenance are counted toward the $10,000 limit. No amount is deductible under the safe harbor for buildings if this limit (or the $1 million adjusted basis limit) is exceeded. The safe harbor is applied separately to each building owned or leased by the taxpayer.

> "The final regulations remove the aggregate ceiling to the de minimis rule. In place of an aggregate ceiling, a more manageable per item or per invoice ceiling now applies."

Eligible property includes a building (including structural components and building systems) owned or leased by a qualifying taxpayer and also portions of buildings that are owned or leased and considered separate units of property under the regulations, such as an individual condominium or cooperative unit or office space. The safe harbor does not apply to costs paid with respect to exterior land improvements that are separate units of property.

IMPACT. *Although the new safe harbor is helpful, small businesses continue to complain that the regulations require costly accounting "paperwork." Nevertheless, under the final regulations, small taxpayers do not have to analyze the building systems.*

COMMENT. *As with the $200 materials and supplies threshold, the IRS is given the authority to adjust the $10,000, 2 percent, and $1 million amounts in the future through published guidance.*

The election is made annually on a timely filed (including extensions) original income tax return. In the case of a partnership or S corporation that owns or leases a building, the partnership or S corporation makes the election. The election may not be made by filing an application for a change in accounting method or on an amended return unless permission to file a late election on an amended return is first obtained. The election is irrevocable.

COMMENT: *A transitional rule allows taxpayers, by filing an amended Federal tax return, to apply the safe harbor as contained in the final regulations to a tax year beginning in 2012 or 2013 even though a timely election was not initially made. This relief is also provided for certain other provisions that require an election.*

BETTERMENTS

In the final regulations, the IRS has clarified the betterment rules and revised two of the betterments tests. Under the temporary regulations, a betterment is defined as an expenditure that:

(1) ameliorates a material condition or defect that existed prior to the acquisition of the property or arose during the production of the property;
(2) *results in* a material addition to the unit of property (including a physical enlargement, expansion, or extension); or
(3) *results in* a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output.

Under the final regulations no change is made to the first betterment test. However,

the second and third tests are changed to eliminate the "results in" standard. Specifically, under the final regulations, a betterment under the two revised standards now includes an expenditure if it:

(1) is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property; or

(2) is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property.

IMPACT. *The elimination of the non-subjective "results in" standard should reduce controversy for expenditures that span more than one tax year or when the outcome of the expenditure is uncertain when the expenditure is made.*

The final regulations clarify that if an addition or increase in a particular factor cannot be measured in the context of a specific type of property, then the factor is not relevant in determining whether there has been a betterment to the property. For example, the "productivity" or "output" standards, while relevant in analyzing a machine, would normally have no relevance to a building structure and, therefore, should be ignored when considering whether expenditures result in a betterment to a building structure.

The final regulations also clarify situations involving refreshing or remodeling retail

FINAL REPAIR/CAPITALIZATION REGULATIONS: TARGETED AREAS

The Preamble to the final regulations within TD 9636 (September 13, 2013) focuses on what changes the IRS made to the 2011 temporary regulations and the reasons behind them. The IRS also used the Preamble to explain the reasons why certain requests for changes made by the public were not adopted by the final regulations. *The following outline of the Preamble may be used as an aid in identifying the many areas addressed by the IRS in drafting the final regulations:*

II. ***Materials and Supplies Under §1.162-3***
- A. *Definition of materials and supplies*
- B. *Election to capitalize certain materials and supplies*
- C. *Optional method for rotable and temporary spare parts*
- D. *Materials and supplies under the de minimis safe harbor*
- E. *Property treated as materials and supplies in published guidance*

III. ***Repairs Under §1.162-4***

IV. ***De Minimis Safe Harbor Under §§1.263(a)-1(f) and 1.162-3(f)***
- A. *De minimis safe harbor ceiling*
- B. *Taxpayers without an applicable financial statement*
- C. *Safe harbor election*
- D. *Written accounting procedures*
- E. *Application to consolidated group members*
- F. *Transaction and other additional costs*
- G. *Materials and supplies*
- H. *Coordination with section 263A*
- I. *Change in accounting procedures not change in method of accounting*

V. ***Amounts Paid to Acquire or Produce Tangible Property Under §1.263(a)-2***

VI. ***Amounts Paid to Improve Property Under §1.263(a)-3***
- A. *Overview*
- B. *Determining the unit of property*
- C. *Unit of property for leasehold improvements*
- D. *Special rules for determining improvement costs*
  1. Costs incurred during an improvement
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- E. *Safe harbor for small taxpayers*
- F. *Safe harbor for routine maintenance*
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  3. Reasonable Expectation that Activities Will be Performed More than Once
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- G. *Betterments*
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     a. Definition of major component and substantial structural part
     b. General rule for major component and substantial structural part
     c. Major component and substantial structural part of buildings
  3. Casualty Loss Rule
  4. Salvage Value Exception
  5. Rebuild to Like-New Condition
- I. *Adaptation to a new or different use*

VII. ***Optional Regulatory Accounting Method***

VIII. ***Election to Capitalize Repair and Maintenance Costs***

IX. ***Applicability Dates***

X. ***Change in Method of Accounting***

stores in particular, by fine-tuning examples in which such actions move from being maintenance activities to betterments that must be capitalized.

IMPACT. *The result of the IRS's clarification of the betterment rules may be less wiggle room for some taxpayers*

COMMENT. *The IRS declined suggestions of quantitative bright lines in applying the betterment rules. However, it added detail in a number of examples within the final regulations to help taxpayers draw the necessary distinctions.*

COMMENT. *Facts and circumstances taken into account in determining whether an expenditure results in a betterment include but are not limited to, the purpose of the expenditure, the physical nature of the work performed, and the effect of the expenditure on the unit of property. The treatment of an expenditure on a taxpayer's applicable financial statement is removed by the final regulations as a factor in considering whether an expenditure results in a betterment since taxpayers apply standards that may differ significantly than the standards in the regulations in determining whether to capitalize a cost for financial accounting purposes.*

RESTORATIONS

The final regulations provide some relief from a rule in the temporary regulations which required a taxpayer to capitalize the entire cost of repairing property that was damaged in a casualty if the taxpayer adjusted the basis of the property as a result of claiming a casualty loss. Capitalization was required even if the adjusted basis of the building (generally, the amount to which the casualty loss is limited) was less than the amounts that could otherwise be deducted as a repair expense. Even if a taxpayer chooses not to claim a casualty loss, the basis adjustment for the loss that could be claimed is required and the deduction of related repair expenses is prohibited under the temporary regulations.

The final regulations revise the casualty loss rule to permit a deduction for amounts spent in excess of the adjusted basis of the property damaged in a casualty event provided they would otherwise be considered deductible repair expenses. A taxpayer is still required to capitalize amounts paid to restore damage to property that would be capitalized without regard to the casualty loss rule, but the costs required to be capitalized under the casualty loss rule are limited to the excess of (1) the taxpayer's basis adjustments resulting from the casualty event, over (2) the amount paid for restoration of damage to the unit of property that are otherwise considered capitalizable restorations. Casualty-related expenditures in excess of this limitation may be deducted as repair expenses if they so qualify.

EXAMPLE: *A storm damages a building with an adjusted basis of $500,000. The cost of restoring the building is $750,000, consisting of a roof replacement ($350,000) and clean-up/repair costs ($400,000). A $500,000 casualty loss is claimed. The cost of the roof must be capitalized as an improvement because it is a major component and substantial structural part of the building. The remaining $400,000 clean/up repair costs must be capitalized to the extent of the $150,000 excess of the building's adjusted basis ($500,000) over the capitalized cost of the roof ($350,000). The remaining $250,000 of repair/clean-up costs ($400,000 - $150,000) may be currently deducted.*

Rebuilt like new. The final regulations retain the rule that a capitalizable restoration includes rebuilding a unit of property to a like-new condition after the end of its class life. A property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications. The final regulations clarify that generally a comprehensive maintenance program, conducted according to the manufacturer's original specifications, even though substantial, does not return a unit of property to like-new condition.

CHANGE IN METHOD OF ACCOUNTING

A taxpayer may choose to apply the final regulations to tax years beginning on or after January 1, 2012, or in certain cases to amounts paid or incurred in tax years beginning on or after January 1, 2012 (application on or after January 1, 2014 is required). The IRS promised in the Preamble to the final regulations to provide separate procedures under which taxpayers may obtain automatic consent for a tax year beginning on or after January 1, 2012, to change to a method of accounting provided in the final regulations. The IRS expects to issue this guidance shortly.

COMMENT. *Most changes in accounting required under the final regulations will require the computation of a Code Sec. 481(a) adjustment. The IRS reported that it anticipates that where a taxpayer seeks to change to a method of accounting that is applicable only to amounts paid or incurred in tax years beginning on or after January 1, 2014, a limited Code Sec. 481(a) adjustment will apply, taking into account only amounts paid or incurred in tax years beginning on or after January 1, 2014, or at a taxpayer's option, amounts paid or incurred in tax years beginning on or after January 1, 2012.*

PROPERTY DISPOSITIONS – RE-PROPOSED MACRS REGULATIONS

The IRS did not finalize or remove the temporary regulations under Code Sec. 168 on general asset accounts and the disposition of depreciable property. Instead, the IRS issued new proposed regulations (REG-110732-13). The proposed regulations will affect all taxpayers that dispose of MACRS property. Because the changes are substantial, the IRS decided it needed to give taxpayers another opportunity to comment.

COMMENT: *The IRS, however, did finalize temporary MACRS regulations dealing with the depreciation of capital expenditures by lessors and lessees and accounting for MACRS property in single item and multiple asset accounts without significant change.*

Dispositions Under Temporary And Proposed Regs

Prior to the temporary regulations, a taxpayer that retired a structural component of a building could not treat the retirement as a disposition and take a loss. Instead, the taxpayer had to continue depreciating the retired component and begin depreciating the replacement component (such as a retired and a new roof). The 2011 temporary regulations, however, treated the retirement of a structural component as a disposition of an asset and required a taxpayer to claim a loss equal to the remaining adjusted basis of the retired structural component. Unfortunately, this rule could have an adverse impact because the repair regulations require the capitalization of amounts paid for the replacement of a component of property that might otherwise be deductible as repair costs if a loss is claimed for the replaced component.

To alleviate this result, the IRS 2011 temporary regulations revised the rules for MACRS general asset accounts (GAAs). Under the revised rules a taxpayer who placed a building or other asset in a general asset account was not required to claim a loss on the retirement of a structural or other component that is considered an asset unless an affirmative election was made to treat the retirement as a "qualifying disposition." Previously, this election for qualifying dispositions was only available in a few select circumstances. Under the temporary regulations the election was expanded to virtually any disposition.

IMPACT. *Assuming an asset was placed in a general asset account, a taxpayer could base the decision on whether or not to treat a retirement of an asset (such as a structural component) as a qualifying disposition on whether or not the replacement costs constituted deductible repair expenses. If the replacement costs were deductible repairs then generally no election would be made to treat the retirement as a qualifying disposition and claim a loss. If an election was made and a loss claimed, the otherwise deductible repair expenses (which would normally far exceed the loss deduction) would need to be capitalized.*

> "The final regulations must be followed by all taxpayers starting in tax years beginning on or after January 1, 2014; the final regulations –or the former temporary regulations— may be followed retroactively back to the start of 2012."

Partial disposition election. To defer a loss on the retirement of a structural component, the temporary regulations required taxpayers to place the building in a general asset account. It seemed more practical to most practitioners to simply make the recognition of gain or loss on the retirement of a structural component or other component that was treated as a separate asset elective. The proposed regulations that were issued on September 13, 2013 adopt this position by creating a "partial disposition" election for assets that are not in general asset accounts. If the election is made, a taxpayer may recognize a loss on the retirement of a structural component. If the election is not made, the taxpayer will continue to depreciate the basis of the retired component.

IMPACT. *The election allows a taxpayer to treat the retirement of any portion of an asset as a disposition. In the case of a building, the entire building is treated as the asset. (Under the temporary regulations, each structural component was treated as an asset and taxpayers were permitted to treat components of structural components as assets). Thus, for example, the taxpayer can make the election to treat the retirement of an entire roof as a partial disposition or any portion of the roof, such as the shingles, as a partial disposition, if it wants to recognize a loss. In the case of assets other than buildings, the partial disposition election may also be made upon the disposition of a component of the asset or a portion of a component of an asset.*

CAUTION. *While the partial disposition rule is generally elective, it is mandatory to recognize gain or loss in the case of certain specified dispositions, including the disposition of a portion of an asset as a result of a casualty, a disposition which is not recognized in whole or part under Code Sec. 1031 or Code Sec. 1033, the transfer of a portion of an asset in a step-in-the-shoes transaction described in Code Sec. 168(i)(7)(B), or to a sale of a portion of an asset.*

The proposed regulations contain an additional rule which protects taxpayers who decide not to treat a retirement as a partial disposition in order to claim a repair deduction but it later turns out on audit that the repair deduction should have been capitalized. The rule allows a taxpayer to file an accounting method change to make the partial disposition election and claim the loss on the replaced component through a Code Sec. 481(a) adjustment in such a situation.

COMMENT: *The partial disposition election for a 2012 or 2013 tax year can be made on an amended 2012 or 2013 return, or alternatively, by filing an accounting method change in the first or second tax year succeeding the applicable tax year.*

Modified general asset account rules. The proposed regulations modify the general asset account rules to redefine a

qualifying disposition for which an election may be made to recognize a gain or loss. A qualifying disposition for which the recognition of gain or loss may be elected under the proposed regulations now generally only includes the few select types of dispositions that were treated as qualifying dispositions prior to the temporary regulations. However, the recognition of gain or loss upon the partial disposition of a portion of an asset is required in the case of any of the transactions described above for assets that are not in a general asset account (i.e., casualty losses, etc.). For other transactions, a disposition includes a disposition of a portion of an asset in a general asset account only if the taxpayer makes the election to terminate the general asset account upon the disposition of all assets, including the disposed portion, in that general asset account.

Timing of finalization. The IRS reported that it aims to finalize the proposed regulations quickly so that they can have the same January 1, 2014 effective date as the final repair regulations. Because the IRS has scheduled a hearing in late December on the proposed regulations, it may not be able to finalize them by January 1, 2014. However, the IRS could decide to apply the regulations retroactively to January 1, 2014. In any case, taxpayers can rely on the proposed regulations for tax years beginning on or after January 1, 2012.