An Analysis of the Final Repair Regulations

By James Atkinson

James Atkinson

James Atkinson is a principal with the Washington National Tax office of KPMG LLP. Atkinson previously served as IRS associate chief counsel (income tax and accounting) and has worked with capitalization principles for more than 20 years. He is a frequent contributor to *Tax Notes*.

In this article, Atkinson discusses the significant changes made by the final repair regulations as well as the proposed changes to the treatment of partial dispositions, and he briefly discusses the next steps that taxpayers should consider.

The information herein is of a general nature and based on authorities that are subject to change. Its applicability to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author only and does not necessarily represent the views or professional advice of KPMG.

Culminating a process that began nearly a decade ago,[1] Treasury and the IRS have finalized most of the repair regulations first proposed in 2006, again in 2008, and reissued as temporary and proposed regulations in December 2011.[2] The final regulations published on September 19, 2013,[3] retain most of the central concepts and standards in the temporary regulations, with several important differences that taxpayers should carefully consider. Among the most important changes are a simplified de minimis safe harbor, a book conformity safe harbor for repair and maintenance (R&M) costs, and a proposed overhaul of the treatment of partial dispositions of tangible property (including the application of general asset accounts).

As with the temporary regulations, the final regulations are designed to apply to nearly all costs a taxpayer incurs in connection with tangible property. For that reason, references to the regulations as ''the repair regulations'' are a misnomer. Instead, the regulations apply to costs incurred throughout the entire life cycle of the taxpayer's tangible property, from the time the taxpayer first begins considering whether (and which) property to acquire, through maintaining and improving the property during its operational life, and finally to the treatment of the property's remaining basis when the taxpayer disposes of the property. The final regulations seek to provide guidance for each of these three buckets of expenditures.

This article discusses the significant changes made by the final regulations, as well as the changes proposed for the treatment of partial dispositions. The article also provides a brief discussion of the next steps that taxpayers should consider, but a detailed discussion of the procedural steps required to implement the final regulations necessarily requires additional guidance from the IRS.[4]

A. The First Bucket — Acquisition Costs

The final regulations contain a handful of clarifications and minor changes to the rules governing the tax treatment of acquisition costs. This section of the regulations also contains one of the most anticipated changes — a simplified de minimis safe harbor likely to benefit most taxpayers.

1. De minimis costs. The temporary regulations permitted taxpayers with an applicable financial statement (AFS)[5] to deduct the aggregate amount of de minimis costs deducted for financial accounting

[1]Notice 2004-6, 2004-1 C.B. 308.

[2]T.D. 9564, 76 F.R. 81060 (the temporary regulations); 73 F.R. 12838; 71 F.R. 48950.

[3]T.D. 9636, 78 F.R. 57686 (the final regulations).

[4]Treasury and the IRS are preparing to issue two revenue procedures providing detailed procedural guidance for implementing the final regulations. That guidance is also expected to address the transition from the temporary regulations to the final regulations by taxpayers who ''early adopted'' the temporary regulations. The guidance is expected to be similar to the transition guidance issued in connection with the temporary regulations. Rev. Proc. 2012-19, 2012-1 C.B. 689; Rev. Proc. 2012-20, 2012-1 C.B. 700.

[5]An AFS is (1) a financial statement required to be filed with the SEC; (2) a certified audited financial statement that is accompanied by the report of an independent CPA (or, for a foreign entity, by the report of a similarly qualified independent professional) that is used for credit purposes; reporting to

(Footnote continued on next page.)

purposes, as long as the amount did not exceed a formulaic ceiling computed as a percentage of the company's book depreciation and gross receipts.[6] Taxpayers objected to this ceiling for a variety of practical and administrative reasons. In response, the final regulations take a much simpler approach. The new rule is an elective $5,000 per-item book-conformity safe harbor.[7]

For taxpayers having an AFS, the safe harbor requires a written de minimis policy consistently applied for financial accounting purposes, under which the taxpayer deducts either items costing less than a stated dollar amount or items having an economic useful life of 12 months or less.[8] As with the temporary regulations, this written book policy must be in place as of the first day of the tax year. Apart from the inclusion of items having a useful life of 12 months or less, the book-conformity aspect of the de minimis safe harbor is unchanged from the temporary regulations.

Rather than applying a ceiling to the taxpayer's aggregate de minimis deductions, however, the final regulations permit the taxpayer to deduct for tax purposes any amount deducted under its book policy that does not exceed $5,000 per invoice (or per item, as substantiated by the invoice). When an item is acquired as part of a bulk purchase, the taxpayer may use a reasonable method to allocate the total invoice price among the items acquired as part of that invoice. For example, the purchase of 10 computers for $40,000 will be deductible under the de minimis safe harbor, regardless of whether the computers are invoiced individually or in the aggregate, as long as they are expensed for book purposes the same year.

Taxpayers having written policies under which amounts greater than $5,000 are deducted for book purposes remain eligible to elect the de minimis safe harbor. When the taxpayer's book policy deducts new purchases costing less than $10,000 per item (for example), the safe harbor will apply to expenditures for items costing no more than $5,000. Items costing between $5,000 and $10,000 (in this example) that are deducted for book purposes potentially may still be deducted for tax purposes as well. The expenditures will not qualify for the de minimis safe harbor but may be deductible if the taxpayer can demonstrate that deducting the larger amounts is immaterial on the taxpayer's facts or otherwise clearly reflects income. As under the temporary regulations, taxpayers and their IRS examination teams remain entitled to reach an agreement under which the IRS will not challenge deductions of amounts exceeding $5,000 per item.[9] Those agreements are relatively common, especially for large companies whose facts support a demonstrably higher materiality threshold.

Similarly, taxpayers whose book policies exclude specific categories of items from the general standard remain entitled to deduct under the de minimis safe harbor those items that are in fact consistently expensed for book purposes. In other words, the presence of carveouts from the book policy will not disqualify the taxpayer's use of the de minimis safe harbor altogether. For example, assume the taxpayer expenses for book purposes all items costing less than $2,500 except for specific parts, the costs of which are expensed only when a part is used or consumed. The taxpayer's election to apply the de minimis safe harbor would not apply to the parts excluded from the book policy but would apply to the other items deducted that year for book purposes. The tax treatment of costs to acquire the excluded parts would be determined under other provisions of the final regulations.

Unlike the ceiling mechanism used in the temporary regulations, the $5,000-per-item approach allows taxpayers to know from the first day of the tax year whether particular expenditures qualify for the safe harbor and should be accounted for as such. The aggregate amount deducted as de minimis costs during a year is no longer relevant, so there is no longer a risk that qualified de minimis amounts may be retroactively disqualified as a result of later purchases. This greater certainty will significantly simplify taxpayers' ability to track and account for de minimis costs throughout the year.

Transaction costs must be included in applying the de minimis safe harbor if those costs are reflected on the same invoice.[10] The taxpayer is not required to (but presumably may) include the transaction costs if they are invoiced separately. For example, if the taxpayer acquires an item for $4,000 and pays a total of $750 for shipping and installation, the single invoice price of $4,750 would be deductible under the de minimis safe harbor as long as the taxpayer deducts those costs for financial accounting purposes as well. If the $750 fees were

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shareholders, partners, or similar persons; or any other substantial nontax purpose; or (3) a financial statement other than a tax return required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the IRS). Reg. section 1.263(a)-1(f)(4).

[6]Reg. section 1.263(a)-2T(g).

[7]Reg. section 1.263(a)-1(f).

[8]Reg. section 1.263(a)-1(f)(1)(i). An alternate rule is provided for smaller taxpayers not having an AFS. The de minimis amount is reduced from $5,000 to $500 per item but otherwise is largely the same. *See* reg. section 1.263(a)-1(f)(1)(ii).

[9]78 F.R. at 57690.

[10]Reg. section 1.263(a)-1(f)(3)(i).

invoiced separately, the final regulations suggest that treating the fees as part of the taxpayer's de minimis costs would be optional. As with the invoice price of a bulk purchase, the taxpayer may use a reasonable method to allocate invoiced transaction costs to the purchased items.

In a significant departure from the temporary regulations, use of the de minimis safe harbor is not an accounting method. Instead, this safe harbor requires an annual, irrevocable election. The election is made by attaching a statement to the taxpayer's original return for the year in which the amounts are paid.[11] To ensure that this election is not inadvertently overlooked, taxpayers should consider adding the de minimis safe harbor to their checklist of annual tax elections.

The regulations' treating this as an annual election rather than an accounting method provides taxpayers considerable flexibility. For example, the taxpayer may change its book de minimis threshold and (without having to obtain IRS consent) follow that new threshold for tax purposes as well. While this added flexibility is certainly welcome, it is unclear why the government chose to make the new safe harbor elective, rather than establishing it as the general rule and allowing taxpayers to opt out of the safe harbor for a given year if desired. Presumably, most taxpayers will choose to make this election each year.

If elected, the de minimis safe harbor sweeps broadly. For example, in addition to purchases of relatively inexpensive fixed assets such as computers, office furniture, and similar items, it will apply to materials and supplies purchased during the year that cost no more than $5,000 and are expensed for book purposes.[12] As a result, the cost of many non-incidental materials and supplies will now be deducted under the de minimis safe harbor when the items are purchased, rather than in the year they are used or consumed as under the general rule for non-incidental materials and supplies. Only if the taxpayer defers deducting those items until used or consumed for book purposes will the de minimis safe harbor not apply and the deduction be deferred for tax purposes. Amending the taxpayer's book accounting policy for those items would allow an immediate deduction for tax purposes.

Perhaps less readily apparent, the de minimis safe harbor also applies to R&M expenses costing no more than $5,000 that are deducted for book purposes. For example, if the taxpayer pays a total of $4,000 in parts and labor to repair a malfunctioning piece of equipment, the de minimis safe harbor will apply to the entire $4,000 payment. As with all other aspects of the final regulations, however, that cost would still need to be tested under section 263A to determine if it must be capitalized under the uniform capitalization rules, regardless of its treatment under section 263(a).[13]

As under the temporary regulations, the de minimis safe harbor is inapplicable to some costs, including amounts paid for property that is or is intended to be included in inventory and amounts paid for land.[14] The de minimis safe harbor also does not apply to amounts spent on rotable, temporary, or emergency spare parts that the taxpayer elects to capitalize and depreciate, or to rotable or temporary spare parts to which the taxpayer applies the optional method of accounting.

2. Materials and supplies. The final regulations' treatment of materials and supplies largely follows that of the temporary regulations, with a few noteworthy exceptions. First, the final regulations slightly modify the definition of materials and supplies to include units of property costing no more than $200, rather than $100 as under the temporary regulations.[15] As a practical matter, this slight modification will not affect most taxpayers electing the de minimis safe harbor.[16]

The final regulations add emergency spare parts as a category of materials and supplies.[17] The regulations include 11 criteria for determining whether an item is an emergency spare part for this purpose, including whether the item is expensive; set aside for use as a replacement to avoid substantial operational time loss caused by emergencies because of particular machinery or equipment failure; located at or near the site of the installed related

[11]Reg. section 1.263(a)-1(f)(5).

[12]Reg. section 1.263(a)-1(f)(3)(ii).

[13]Reg. section 1.263(a)-1(f)(3)(v). The preamble to the final regulations includes an interesting discussion of the interaction of the de minimis safe harbor and the section 263A uniform capitalization rules. The preamble underscores the importance of the taxpayer's expectations at the time of acquisition whether the acquired property will be used in a production activity. As with other areas of the regulations, hindsight is not used to change the taxpayer's expectation or the tax treatment of the costs once properly deducted under the de minimis safe harbor. *See* 78 F.R. at 57691.

[14]Reg. section 1.263(a)-1(f)(2).

[15]Reg. section 1.162-3(c)(1)(iv).

[16]An issue is emerging for taxpayers whose book policies may in some situations require capitalizing units of property costing $200 or less. The issue will be of particular interest to companies that apply their book minimum capitalization policies at the invoice level rather than the item level (*e.g.*, taxpayer replaces all telephones in its office building and spends $50,000 in doing so. Each telephone costs $50, and so should be deducted for tax purposes as a material or supply, but may be capitalized under the taxpayer's book capitalization policy if that policy looks to the aggregate cost of the telephone replacement).

[17]Reg. section 1.162-3(c)(3).

machinery or equipment to be readily available when needed; only available on special order and not readily available from a vendor or manufacturer; not subject to normal, periodic replacement; not repaired and reused; and others. The classic example of an emergency spare part is a spare generator held on site at an electric power plant to avoid service disruptions.[18] Parts that rotate in and out of service on an as-needed basis (even if used only in emergencies) are accounted for as rotable spares rather than as emergency spares.

Unlike the treatment for rotable and temporary spare parts, the final regulations do not contain special timing rules for emergency spare parts differing from the ones generally applicable to routine materials and supplies. Under the general rules, the cost of a non-incidental material or supply (presumably including any emergency spare) is deducted in the year the item is used or consumed.[19] If the emergency spare part costs no more than $5,000 and is deducted when acquired for book purposes, the cost would be deducted in the year acquired by a taxpayer electing the de minimis safe harbor. When, as is likely, the emergency spare costs more than $5,000, the costs generally would be recovered when the part is first used or consumed, as is the case with other non-incidental materials and supplies. Alternatively, the taxpayer can elect to capitalize and recover the cost of the emergency spare part through depreciation.[20]

Finally, unlike the temporary regulations, the final regulations do not permit a taxpayer to elect to capitalize and depreciate all costs incurred for materials and supplies. Instead, this election now is available only for costs incurred to acquire rotable, temporary, and emergency spare parts.[21]

B. The Second Bucket — Repair Costs

As under the temporary regulations, the R&M section of the final regulations is likely to be the focus of most taxpayers. Here, many of the basic standards and principles remain unchanged from the temporary regulations, with a few noteworthy exceptions.

1. Capitalization safe harbor. The final regulations contain a much-anticipated book-conformity capitalization safe harbor. Unlike a pure book-conformity rule under which the tax treatment of R&M costs would mirror the book treatment of those costs, however, the final regulations' safe harbor operates in only one direction to permit otherwise deductible costs to be capitalized. As a practical matter, relatively few R&M costs expensed for book purposes are likely to be treated as capital improvements under the final regulations, so in most circumstances the bottom line will probably be the same.

Following publication of the temporary regulations, many companies expressed a preference for following their book capitalization policy for R&M costs rather than sorting through and implementing the factual and often administratively difficult standards otherwise required to distinguish a deductible repair from a capital improvement for tax purposes. Those taxpayers believed that the inherently conservative nature of financial accounting would nearly always result in the company capitalizing aggregate costs in excess of those likely to be capitalized under the tax regulations. Because the temporary regulations did not specifically sanction this approach, however, many companies and their tax advisers were reluctant to formally endorse a knowing disregard of the regulations.

The final regulations have largely alleviated this conundrum. Under the new capitalization safe harbor, the taxpayer may elect to treat as capital expenditures for tax purposes those R&M costs that it treats as capital improvements on its books and records.[22] If elected, the safe harbor applies to all R&M costs that the taxpayer incurs during the year that are treated as capital improvements on its books and records. The safe harbor cannot be applied, however, to R&M costs incurred in connection with rotable or temporary spare parts to which the taxpayer applies the optional accounting method of reg. section 1.162-3(e).[23]

The capitalization safe harbor by its terms applies only to amounts paid for R&M. As such, other costs incurred in connection with tangible property — such as amounts incurred to purchase materials and supplies or other fixed assets — will not be affected by this election regardless of the book treatment of those expenditures. Also, amounts for which a deduction is provided by a code section other than section 162(a) likewise should remain deductible. Thus, for example, intangible drilling costs would remain subject to the specific cost recovery rules governing those expenditures for tax purposes, regardless of the manner in which the taxpayer accounts for the costs for nontax purposes.

The book capitalization safe harbor is an annual election rather than an accounting method. The election is made by attaching a statement to the taxpayer's original return for the year in which it

[18]*See, e.g.*, Rev. Rul. 81-185, 1981-2 C.B. 59.
[19]Reg. section 1.162-3(a)(1).
[20]Reg. section 1.162-3(d).
[21]*Id*.
[22]Reg. section 1.263(a)-3(n)(1).
[23]Reg. section 1.263(a)-3(n)(3).

incurs the amounts to be capitalized.[24] By treating the safe harbor as an annual election, the government effectively locks in the taxpayer's decision to capitalize amounts that otherwise might be deductible for tax purposes that year. The taxpayer loses the ability to correct or reverse the effect of prior capitalization decisions through an accounting method change and section 481(a) adjustment, or through a claim for administrative adjustment on audit. The consequence is that upon IRS examination, the taxpayer has irrevocably committed to capitalizing a range of expenditures, while the IRS may still challenge the taxpayer's entitlement to deduct for tax purposes any costs that have been expensed for book purposes as well. Even though the conservative nature of most taxpayers' financial accounting policies is likely to minimize the potential IRS audit exposure, it generally will be worthwhile to review the R&M items expensed under those policies to ensure compliance with the final regulations.

In considering whether to elect the book capitalization safe harbor, taxpayers must keep in mind the election's all-or-nothing nature. For example, taxpayers with expansive book capitalization policies will lose the ability to deduct potentially costly replacements of major components that may be deductible under the routine maintenance safe harbor (RMSH). As such, it is important to weigh the administrative and compliance advantages of the capitalization safe harbor with the potential tax benefits irrevocably forgone under the election. Ideally, this cost-benefit analysis should be performed annually in light of the extent and nature of the year's R&M costs.

2. Major components/substantial structural parts. The final regulations leave intact the unit of property standards in the temporary regulations. The government adhered to its position that while a building is the relevant unit of property, the capitalization standards must be applied not to that unit of property but instead to the building structure and to each of eight separate building systems identified in the regulations.[25] Non-building property generally remains subject to the functional interdependence test. Plant property and network assets, as defined in the regulations, remain subject to the special rules in the temporary regulations.[26]

In applying the capitalization standards discussed below, taxpayers must further divide the identified units of property into major components and substantial structural parts. Absent an available exception, costs to replace a major component or substantial structural part must be capitalized.

A major component is a part or combination of parts that performs a "discrete and critical function."[27] The regulations do not explain the difference between the "discrete and *critical* function" standard for major components and the "discrete and *major* function" standard used in identifying units of property for plant property.

Because the major component standard must be applied by a wide range of taxpayers in nearly every sector of the economy, the government left the term somewhat vague. As elsewhere in the regulations, the term is clarified in large part through examples, under which major components are found to include:

- the engine and the cab of a truck[28];
- underground storage tanks within a gas station fuel dispensing system[29];
- the entire roof of a building (including the decking, insulation, asphalt, and coatings)[30];
- three furnaces (collectively) within a building's HVAC system[31];
- the chiller unit of an HVAC system[32];
- the sprinkler system within a building's fire protection and alarm system[33]; and
- the wiring within a building's electrical system.[34]

In contrast, major components do not include incidental components of the unit of property, even though the component performs a discrete and critical function in the operation of the unit of property. For example, even though a piece of equipment will not operate without a power switch, the power switch is not considered a major component under the final regulations.[35] Major components also do not include a roof's rubber membrane[36]; one of three furnaces within a building's HVAC system[37]; three of 10 roof-mounted

[24]Reg. section 1.263(a)-3(n)(2).
[25]Reg. section 1.263(a)-3(e)(2).
[26]Reg. section 1.263(a)-3(e)(3). *See* James Atkinson, "Repair and Maintenance of Plant Property: New Insights," *Tax Notes*, July 1, 2013, p. 69.
[27]Reg. section 1.263(a)-3(k)(6)(i)(A).
[28]Reg. section 1.263(a)-3(k)(7), Example 10.
[29]*Id.*, Example 12.
[30]*Id.*, Example 14.
[31]*Id.*, Example 16.
[32]*Id.*, Example 17.
[33]*Id.*, Example 19.
[34]*Id.*, Example 20.
[35]*Id.*, Example 13.
[36]*Id.*, Example 15.
[37]*Id.*, Example 16.

units within a building's HVAC system[38]; 30 percent of the wiring within a building's electrical system[39]; or eight of 20 sinks within a building's plumbing system.[40]

For buildings, replacing a major component also includes replacing a significant portion of the major component.[41] The special rule for major components within buildings was needed because many building components are composed of numerous identical pieces functioning collectively. For example, under the final regulations all sinks within a building are treated as a single major component of the building's plumbing system[42]; all rooftop units collectively are a major component of the building's heating, venting, or air conditioning system[43]; and all exterior windows collectively are a single major component of the building's structure.[44] Thus, replacing a significant portion of the sinks within a building will be treated as the replacement of a major component of the building's plumbing system, even if not all sinks are replaced.

While the regulations do not define a significant portion for this purpose, accompanying examples suggest that replacing 30 percent of a major component will not require capitalization, but replacing 40 percent may.[45] Interestingly, the final regulations do not provide the same significant portion standard for major components of non-building property, leaving open the question whether a taxpayer must replace 100 percent of a major component of non-building property before capitalization is required.

The final regulations provide a separate definition for substantial structural part. As with major components, the term is relevant because costs to replace a substantial structural part generally must be capitalized, unless the routine maintenance safe harbor is applicable. A substantial structural part is a part or combination of parts that comprises a "large portion of the physical structure of the unit of property." While the definition of major component focuses on functionality, the definition of substantial structural part instead focuses on size. Again, the standard is left vague, with examples used to provide as much clarity as possible given the inherently factual nature of the inquiry. The examples indicate that substantial structural parts may include, for example, one-third of a building's exterior windows, when the building's exterior windows comprise 90 percent of its total surface area.[46]

In all likelihood, identifying major components and substantial structural parts will be one of the toughest challenges under the final regulations. This is likely to be a topic of conversation for taxpayers and the IRS for years to come, as both sides seek to determine which parts are discrete and critical or merely incidental (while also being discrete and critical), and how large a component can be without being a substantial structural part. This determination may prove to be just as challenging as attempting to identify the taxpayer's units of property.

3. Capitalization standards. By and large, the final regulations leave unchanged the core capitalization standards articulated in the temporary regulations. As before, a taxpayer generally must capitalize costs incurred to better or to restore a unit of property, or to adapt it to a new or different use.[47] Each of those three categories has specific definitions and factors, none of which are significantly different from those of the temporary regulations. The final regulations instead clarify or slightly modify some of the rules and provide several new or revised examples to help clarify or better demonstrate the general concepts.

Discussions of these capitalization standards tend to focus on two of the three categories of capital improvements: betterments and restorations. The third category — adaptation of the unit of property to a new or different use — historically has presented fewer problems, but when a problem does arise, resolving it can be difficult. With this in mind, the final regulations provide additional guidance through three new examples. In one, the government concludes that the taxpayer must capitalize costs incurred to convert part of a retail drugstore building into a medical clinic in which customers can obtain vaccinations and other basic medical services. The regulations conclude that on the facts of the example, the use of the building to provide clinical medical services is inconsistent with the taxpayer's intended, ordinary use of the building at the time it was placed in service. Costs to convert the building structure, plumbing system, and electrical system to accommodate the new medical clinic were thus capitalized.[48]

However, the final regulations conclude that capitalization is not required when a hospital converts an existing emergency room facility to provide

[38]*Id.*, Example 18.
[39]*Id.*, Example 21.
[40]*Id.*, Example 23.
[41]Reg. section 1.263(a)-3(k)(6)(ii)(A).
[42]Reg. section 1.263(a)-3(k)(7), Example 22.
[43]*Id.*, Example 18.
[44]*Id.*, Example 25.
[45]*Id.*, examples 21 and 29.
[46]*Id.*, Example 27.
[47]Reg. section 1.263(a)-3(j)-(l).
[48]Reg. section 1.263(a)-3(l)(3), Example 5.

both emergency care and outpatient surgery. The regulations conclude that the provision of outpatient surgery is consistent with the hospital's intended, ordinary use of the building in its clinical medical care business.[49]

Finally, the regulations conclude that capitalization is not required when a grocery store incurs costs to add a sushi bar at which customers can order freshly prepared sushi for takeout or to eat at a newly installed counter. The grocery store already contained counters where customers could order deli meats, prepared foods, and baked goods made to order. The government concluded that the sale of sushi is consistent with the grocery store's intended, ordinary use of the building — selling food to customers at various specialized counters — and that as a result, many of the costs of the new sushi bar were not required to be capitalized.[50]

This example may prove particularly beneficial for retailers who periodically incur costs to reconfigure and rearrange sales floors by, for example, swapping the locations of two or more existing departments, or eliminating one department in favor of a new one. Because converting a portion of the retail space into a sales area focused on a different line of merchandise would be consistent with the retailer's intended, ordinary use of the building when it was placed in service, the final regulations would support deducting those expenditures.

4. Routine maintenance safe harbor. The final regulations retain the RMSH.[51] Whereas the temporary regulations made the safe harbor inapplicable to buildings, the final regulations permit it to be applied to buildings, with an important modification. The RMSH generally looks to the frequency of expected R&M activities within the unit of property's alternative depreciation system recovery period, but for buildings that testing period is limited to 10 years.[52] As such, for buildings, the RMSH will apply to R&M activities that the taxpayer expects to perform at least twice within 10 years. For most companies, this will substantially limit the potential application of the RMSH for buildings. While it may be applicable to companies that periodically refresh retail stores or other public spaces every five years by painting, replacing ceiling tiles, or similar activities, it will be unlikely to apply to more costly (but less frequent) maintenance such as the replacement of HVAC components or roofs.

In another change from the temporary regulations, the final regulations exclude network assets from the scope of the RMSH. To date, the government has issued industry-specific guidance regarding network assets used in the telecommunications[53] and electric utility industries.[54] Each of those revenue procedures has included an optional safe harbor method that industry members can use to determine deductible R&M expenses for specific categories of network assets, without having to apply the regulations' general rules to those assets. Similar guidance is pending for network assets used in the cable television and natural gas transmission and distribution industries. The exclusion of network assets from the scope of the RMSH may signal the government's desire to encourage members of these industries to use the specific R&M safe harbors tailored for them, rather than the more general RMSH.

5. Removal costs. The final regulations provide a new and relatively straightforward standard for determining the deductibility of removal costs.[55] Removal costs are deductible if, for federal tax purposes, the taxpayer disposes of the depreciable asset being removed and takes its basis into account in realizing gain or loss. However, if the taxpayer removes a component of a unit of property but the removal is not treated as a disposition for federal tax purposes, the taxpayer deducts or capitalizes the removal costs based on whether those costs directly benefit or are incurred by reason of a repair to the unit of property or an improvement to the unit of property. Stated more simply, if the taxpayer recognizes gain or loss on the disposal, the removal costs are deductible. Otherwise, the treatment of the removal costs depends on whether the removal of the old property is undertaken as part of a capital improvement of other property.

For example, assume the taxpayer discovers a leak in a building's roof. The taxpayer removes a portion of the roof, repairs the leak, and replaces the roof components that had been removed in order to reach the leaking area (shingles, etc.). If the taxpayer recognizes a disposition loss for the removal of the old roofing material, the related removal costs would be deductible.[56] If the taxpayer does not recognize a disposition loss for the removal of the

[49]*Id.*, Example 7.
[50]*Id.*, Example 6.
[51]Reg. section 1.263(a)-3(i).
[52]Reg. section 1.263(a)-3(i)(1)(i).

[53]Rev. Proc. 2011-27, 2011-1 C.B. 740 (telephone wireline assets); Rev. Proc. 2011-28, 2011-1 C.B. 743 (telephone wireless assets).
[54]Rev. Proc. 2011-43, 2011-37 IRB 326 (electric transmission and distribution property). *See also* Rev. Proc. 2013-24, 2013-1 C.B. 1142 (electric generation property).
[55]Reg. section 1.263(a)-3(g)(2). Presumably the final regulations supersede Rev. Rul. 2000-7, 2000-1 C.B. 712.
[56]Reg. section 1.263(a)-3(g)(2)(ii), Example 4.

old roofing material, the deductibility of the removal costs depends on whether the taxpayer deducts the costs of the roof maintenance as an ordinary repair or instead must capitalize the costs as a betterment or restoration of the roof.[57]

6. Casualty losses. The treatment of R&M costs following a casualty event has been one of the most frequently discussed aspects of the tangible property regulations since they were first proposed in 2006. Although the stated rationale has evolved with each version of the repair regulations,[58] the government has consistently taken the position since 2006 that costs of restoring damage following a casualty event must be capitalized under section 263(a). Many taxpayers, particularly those in the electric utility industry, have disagreed, contending instead that sections 162 and 165 must be analyzed independently.[59]

The final regulations take the middle ground in seeking to resolve this controversy. If the taxpayer reduces the basis of the damaged property following a casualty event, costs incurred to restore the damage must be capitalized at least to the extent of that basis adjustment. When the costs to restore the damage exceed the amount of the basis adjustment resulting from the casualty, the deductibility of the excess expenditures depends on whether the activity constitutes a betterment, restoration, or adaptation of the property to a new or different use under the generally applicable capitalization standards. If not, the excess costs generally would now be deductible as repairs under section 162(a).[60]

C. The Third Bucket — Dispositions

Rather than finalize the disposition rules contained in the temporary regulations, the government has instead proposed a completely new approach for dispositions of depreciable tangible property. The proposed rules seek to allow the same general treatment of partial dispositions, but without the use of general asset accounts (GAAs). The government anticipates that the proposed changes to the disposition rules will be effective beginning with 2014 tax years.

In developing the temporary regulations, the government attempted a delicate balancing act under which taxpayers would be allowed to recover the remaining basis of a component of a unit of property that was being replaced, but required to capitalize the costs of replacing that component. The difficulty was that in many cases, the potential repair deduction exceeded the potential loss deduction from the partial disposition. The government sought to give taxpayers flexibility in determining whether to claim the disposition loss or instead claim a deduction for the costs of replacing the disposed component. The government also sought a way to allow taxpayers to disregard relatively insignificant partial dispositions, and to instead continue depreciating the property's remaining basis without change.

The mechanism chosen by the government for striking this balance in the temporary regulations was an expansion of the GAA rules. Under the temporary regulations, taxpayers were allowed to place property into GAAs as a way of gaining the flexibility to claim a loss deduction upon the partial disposition of property held in a GAA (and forgo any otherwise allowable repair deduction), or instead to leave the depreciable basis of the GAA unchanged and deduct the cost of related repairs. In addition to being entitled to make an annual GAA election for newly acquired assets, the government provided a limited window within which taxpayers could make a late GAA election to place into GAAs assets acquired before 2012.[61] Under the temporary regulations, widespread use of GAAs to gain this flexibility regarding partial dispositions seemed a foregone conclusion.

In response to comments and concerns that the GAA rules were too administratively complex, however, the government has issued proposed regulations providing a simpler way to achieve the flexibility previously available only through the use of a GAA, while in turn reverting the use of GAAs to their original, more limited application.[62] Under the proposed regulations, taxpayers would have flexibility in determining whether to recognize some partial dispositions *only* if the property remains treated as a separate depreciable asset (that is, *not* placed in a GAA). Decisions affecting whether and how to account for partial dispositions would be deferred until that disposition actually occurs, rather than in the year in which the property is acquired, as was the case under the temporary regulations.

Under the proposed general rule, the property being disposed of will be an entire building, for example, rather than individual building components.[63] The disposition of the entire building will

[57]Reg. section 1.263(a)-3(g)(2)(ii), Example 3.

[58]*Compare* 71 F.R. at 48603 *with* 73 F.R. at 12846, *with* 76 F.R. at 81073, and *with* 78 F.R. at 57698. *See also* John Barrick, "Post-Casualty Expenses Under the Temporary Regulations," *Tax Notes*, May 7, 2012, p. 755.

[59]*See, e.g.*, comment letter of Edison Electric Institute (July 11, 2012); comment letter of Ivins, Phillips & Barker (June 3, 2008).

[60]Reg. section 1.263(a)-3(k)(4).

[61]Rev. Proc. 2012-20.

[62]REG-110732-13, 78 F.R. 57547.

[63]Prop. reg. section 1.168(i)-8(c)(4).

be treated under the normal rules governing complete dispositions. When the taxpayer disposes of less than the entire building (voluntarily or involuntarily), however, the proposed general rule would require the taxpayer to recognize gain or loss on that partial disposition in four situations: (1) a casualty event; (2) the deferral of gain under section 1031 or 1033; (3) the transfer of assets in a section 167(i)(7)(b) ''step in the shoes'' transaction; or (4) a sale of a portion of the asset. For example, if the taxpayer sells a one-half interest in the building, the normal rules for determining gain or loss on that sale must be applied. Similarly, if the building's roof is destroyed in a hurricane, the casualty loss rules apply.

For any other transaction, the proposed regulations generally would ignore the partial disposition for tax purposes, and the taxpayer would continue depreciating the property as before. The proposed regulations would allow the taxpayer to elect to recognize the partial disposition for tax purposes, however, as long as the property is not held in a GAA.[64] The election would allow the taxpayer to recover the remaining basis in whatever portion of the building that has been disposed of, and the costs of replacing that portion of the property would be capitalized under the restoration standards of reg. section 1.263(a)-3(k). The election is made on the taxpayer's original return for the year in which the partial disposition occurs, and once made can be revoked only with IRS consent (through the filing of a private letter ruling request, rather than a request to change accounting methods).[65]

Importantly, this election can be made for the disposition of any ''portion'' of tangible property, rather than for a specific ''component,'' as was the rule under the temporary regulations. This distinction is not merely semantic. Instead, it avoids the need for taxpayers to separately identify and track the components of buildings and other tangible property beginning in the year of acquisition. Instead, as long as the property is not held in a GAA, all decisions regarding how to account for any partial disposition of any portion of the property will be deferred until the year in which the disposition occurs. By allowing the taxpayer to make important tax decisions in the year in which all the facts and relevant considerations are known, this approach will simplify application of the partial disposition rules.

At the same time, the proposed regulations would restore the use of GAAs to what the government believes to be their originally intended function — allowing taxpayers to place into one or more GAAs many items of property that the taxpayer prefers not to track separately. Once placed into a GAA, the property's basis generally is recovered over its prescribed depreciable life, and dispositions are disregarded except in the limited circumstances applicable before the temporary regulations.[66] In other words, the GAA rules have been returned to their pre-temporary-regulation operation, without change.

As before the temporary regulations, GAAs may be advantageous in some situations. For example, for taxpayers that for administrability reasons do not care to or cannot separately track each depreciable asset and its actual disposition date, GAAs provide a convenient way to essentially place the property into a GAA and forget about it. GAAs also provide flexibility for taxpayers in managing net operating losses. The ability to use GAAs for those purposes would remain unchanged under the proposed regulations.

In summary, the proposed disposition regulations would provide taxpayers the same flexibility whether to recognize a loss upon a partial disposition of tangible property not held in a GAA that was available only through the use of a GAA under the temporary regulations. Further, the proposed regulations would amend the GAA rules to once again prohibit a taxpayer from claiming a loss upon the disposition of only a portion of tangible property held in a GAA, except under limited circumstances (generally, the same circumstances that existed before the temporary regulations). As a result, while use of GAAs may still be advantageous in some situations, taxpayers seeking the flexibility to choose whether to recognize a partial disposition loss immediately or to instead continue depreciating the property's basis without adjustment generally will prefer not to include tangible property in a GAA.

D. Next Steps

The inherently factual nature of the final regulations, coupled with the varying approaches taken by taxpayers over the past 10 years in responding to the various iterations of proposed and temporary regulations, make it difficult to prescribe a universal

[64]Prop. reg. section 1.168(i)-8(d)(2).

[65]Unlike the elections for the book-conformity capitalization safe harbor and the de minimis safe harbor, the partial disposition election is made by taking the position on the taxpayer's original federal tax return for the year of the transaction, without the need for a specific statement. Prop. reg. section 1.168(i)-8(d)(2)(ii)(B).

[66]Prop. reg. section 1.168(i)-1(e).

The Final Tangibles Regulations: Key Changes to Temporary Regulations		
	Temporary Regulations	**Final Regulations**
Acquisition Costs		
De minimis costs	• Aggregate costs deducted for book purposes are deductible for tax, capped by a formulaic ceiling • De minimis rule is an accounting method	• Individual items costing no more than $5,000 deductible for tax if also deducted under a written book policy ($500 per item without an AFS) • Annual, irrevocable election • Election includes all qualified costs, including materials and supplies; no cherry-picking • Transaction costs included in de minimis amount if included on same invoice
Materials and supplies	• Among others, includes items costing no more than $100	• Among others, includes items costing no more than $200
Emergency spare parts	• No provision	• Emergency spare parts defined; costs recovered under general material and supplies rules
Election to capitalize materials and supplies	• Taxpayer may elect to capitalize and depreciate any materials and supplies	• Taxpayer may elect to capitalize and depreciate only rotable, temporary, and emergency spares
Repair and Maintenance Costs		
Capitalization safe harbor	• No provision	• Taxpayer may elect annually to capitalize for tax purposes repair and maintenance costs capitalized under a written book policy • Annual election applies to all repair and maintenance costs capitalized for book purposes; no cherry-picking
Routine maintenance safe harbor	• Inapplicable to building property	• Applies to buildings using a 10-year testing period • Inapplicable to network assets
Casualty losses	• Capitalization required for any restoration/repair costs if taxpayer recognizes a casualty loss	• Restoration/repair costs up to casualty-related basis adjustment capitalized; excess amounts tested under capitalization standards
Removal costs	• No provision	• Removal costs deductible if gain or loss recognized on disposition • Removal costs deductible if gain or loss not recognized on disposition and the maintenance activity is not an improvement
Major components and substantial structural parts	• Identified based on total facts and circumstances	• Major components: "discrete and critical" function within UOP • For buildings, includes "significant portion" of major component • SSP: "large portion of the physical structure" of UOP
Dispositions (Proposed)		
Partial dispositions	• Permitted only for property in general asset accounts	• Permitted only for property not in general asset accounts • Annual election, disposition-by-disposition

set of next steps for implementing the final regulations. The optimal approaches for implementing the regulations likely will be clarified when the government issues the anticipated transition guidance. That guidance will take the form of two revenue procedures setting out the mechanical rules for making the method changes needed to unwind prior actions that taxpayers may have taken under earlier versions of the regulations and to implement the new accounting methods required by the final regulations.

In the meantime, a taxpayer should first determine its ultimate goal in applying these regulations. While some companies seek to ensure basic compliance with the standards and avoid potential audit issues with the IRS, others seek to maximize the potential deductions to which they may be entitled under the regulations. Clarifying the company's ultimate objective and risk tolerances will play a major role in determining the company's approach to implementing the final regulations.

Companies seeking to rely on one or both of the available book-conformity safe harbors should quickly determine whether they have the required written policies in place, whether those policies reflect the balance that the company desires for both book and tax purposes in accounting for tangible property, and whether the policies are consistently followed. If not, the company should consider what, if any, adjustments are desirable, so that the changes can be in place before the first day of the tax year in which the book-conformity safe harbors will be elected.

Companies also should begin considering whether the units of property, as well as the major components and substantial structural parts of those units of property traditionally used by the company for tax, book, or other purposes, comply with the standards required by the final regulations. If not, because this can be one of the most time-consuming aspects of the new regulations for many companies, efforts to reexamine and adjust those definitions should begin as soon as practicable.

Other steps will likely be necessary, depending on the company's specific facts and circumstances. Given the inherently factual nature of the regulations, it is never too early to start reviewing the new rules and to develop a game plan consistent with the company's facts and objectives.