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ACCOUNTING

Repairs vs. Capital Improvements: Do the Final Regulations at Last Clarify the Distinction?

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Additional numerical examples and taxpayer-friendly simplifications are very helpful, but there's no getting around the fact that multiple sets of rules continue to make this an extremely complicated area of the tax law.

Almost two years after issuing re-Proposed and Temporary Regulations, Treasury and the IRS published the long-awaited final tangible property Regulations (**TD 9636**, 9/19/13) addressing the distinction between currently deductible repair expenses and capital improvements, and other capitalization rules for tangible property. The Regulations package also includes proposed rules for the disposition of tangible property. **1** The final Regulations are generally effective for tax years beginning after 2013, but taxpayers may choose to apply them to tax years beginning after 2011.

The final Regulations are the result of a ten-year-long undertaking by Treasury and the IRS to provide

clearer guidelines for the treatment of expenditures relating to the repairs and improvement of tangible property used in a trade or business. The process included the issuance of comprehensive Proposed Regulations in 2006, a significantly revised version in 2008, another revised version in 2011 that also was issued in temporary form (and optionally effective for tax years beginning after 2011), **2** and now the final Regulations that are effective for tax years beginning after 2013. **3**

The principal question the final Regulations address is whether expenditures relating to the maintenance and alteration of tangible property, including buildings and other fixed assets, are properly treated as repairs, which are currently deductible, or are required to be capitalized as an improvement to the property and thus depreciated over the asset's tax depreciation recovery period. In addition, the final Regulations provide revised guidance for determining the types of costs that are required to be capitalized with respect to the acquisition of tangible property for use in a trade or business, including a new safe harbor for current expensing of de minimis items, and more-detailed guidance on the treatment of materials and supplies and spare parts. These Regulations do not finalize or remove the 2011 Temporary Regulations regarding dispositions of tangible property; rather, the proposed disposition rules have been withdrawn, significantly revamped and simplified, and issued in re-proposed form.

The following provides a general overview of the final Regulations, and summarizes key changes between the 2011 Regulations and the final tangible property Regulations, and re-Proposed disposition rules. See Exhibit 1 for a summary of the key changes between the 2011 Regulations and the final and re-Proposed Regulations.

OVERVIEW

As with the 2011 Regulations, the final Regulations provide a general framework for distinguishing capital and depreciable business expenditures from supplies, repairs, maintenance, and other deductible business expenses. They retain many of the provisions and adopt the same general format as the 2011 Regulations:

- Reg. 1.162-3 provides rules for materials and supplies.
- Reg. 1.162-4 addresses repairs and maintenance.
- Reg. 1.263(a)-1 provides general rules for capital expenditures.
- Reg. 1.263(a)-2 provides rules for amounts paid for the acquisition or production of tangible property.
- Reg. 1.263(a)-3 provides rules for amounts paid for the improvement of tangible property.

Nevertheless, the final Regulations also refine and simplify some of the rules contained in the 2011 Regulations.

COSTS TO ACQUIRE TANGIBLE PROPERTY

Reg. 1.263(a)-2 is consistent with the general rule from the 2011 Regulations requiring a taxpayer to capitalize amounts paid to acquire or produce a unit of real or personal property. Under this rule, capitalization of the related transaction costs-i.e., costs incurred in the process of investigating or otherwise pursuing the acquisition-also is required, subject to two exceptions:

(1) Taxpayers are not required to capitalize transaction costs incurred prior to reaching a decision on whether to acquire real property, and which property to acquire, unless the costs are "inherently facilitative," based on a broad definition of that term. **4**

(2) Taxpayers are not required to capitalize transaction costs that are employee compensation or overhead costs. **5**

The first exception continues to be limited to real property acquisitions, rendering allocations necessary when an acquisition involves a combination of real and personal property, **6** while the second is available for acquisitions of both real and personal property. **7**

De Minimis Rule

The 2011 Regulations provided a de minimis exception permitting qualified taxpayers to deduct certain amounts paid for tangible property, but limited to an overall dollar ceiling amount. Based on numerous comments that the ceiling would be administratively unworkable for most businesses, large and small, the final Regulations replace the ceiling with a safe harbor determined at the invoice or item level and based on the policies that the taxpayer uses for its financial accounting books and records.

Under the final Regulations, a taxpayer with an applicable financial statement may rely on the de minimis safe harbor if it has a written policy as of the beginning of the year that provides for expensing either items costing less than a specified dollar amount or that have a useful life of not more than 12 months. If the taxpayer has such a policy, to the extent it adheres to the policy, then the safe harbor applies to amounts paid for property that does not exceed \$5,000 per invoice (or per item if the invoice itemizes their cost). 8

A taxpayer may seek a deduction for amounts in excess of the amount allowed by the safe harbor but has the burden of showing that such treatment clearly reflects income. The Preamble to **TD 9636** states, however, that if examining agents and a taxpayer agree that certain amounts in excess of the de minimis safe harbor limitations are not material or otherwise should not be subject to review, that agreement should be respected, notwithstanding the requirements of the de minimis safe harbor. For example, if the taxpayer's written policy provides for expensing items that cost more than \$5,000 each, then as long as the taxpayer adheres to its policy the taxpayer's method of accounting does not violate the requirements of the safe harbor to the extent of items actually costing less than \$5,000, and cannot be considered an impermissible method for that reason.

Nevertheless, the final Regulations change the rule in the Temporary Regulations with respect to the interaction between the de minimis rule and the uniform capitalization rules. Under the Temporary

Regulations, amounts eligible for the de minimis rule could not be subjected to capitalization under the uniform capitalization rules. **9** The final Regulations change that and provide that amounts otherwise deducted under the de minimis rule must be capitalized if incurred for the benefit of a production or resale activity, including a capital improvement under the final Regulations. **10**

The final Regulations provide that the de minimis rule is elected annually by including a statement on the taxpayer's timely filed original federal tax return for the year elected. If elected, the de minimis safe harbor must be applied to all amounts paid in the tax year for tangible property that meets the requirements under the safe harbor, including amounts paid for materials and supplies that meet the requirements. In addition, the final Regulations provide that a taxpayer may not revoke an election to use the de minimis safe harbor.

The final Regulations allow a taxpayer to file an amended return up to 180 days after the extended due date of its tax return for tax years starting after 2011 and ending before 9/20/13 to make a proper election to adopt the de minimis safe harbor if the election was not made on its timely filed original return. Thus, calendar-year taxpayers that have recently filed their 2012 tax returns should analyze the impact of the changes to the de minimis safe harbor implemented by the final Regulations and consider the opportunity to file an amended return within the 180-day window. A taxpayer cannot amend, however, if it did not have a written policy in place at the beginning of the tax year.

Materials and Supplies

The final Regulations retain the framework and many of the rules set forth in the 2011 Regulations with regard to both the definition of materials and supplies **11** and the available accounting methods for materials and supplies, **12** but incorporate some key changes.

First, the final Regulations expand the definition of materials and supplies to include (1) property that has an acquisition or production cost of \$200 or less (increased from \$100 or less under the 2011 Regulations); and (2) standby emergency spare parts.

Second, the final Regulations limit the rule permitting taxpayers to elect to capitalize and depreciate (rather than deduct when consumed or disposed of) amounts paid for materials and supplies to rotable, temporary, or standby emergency spare parts. **13** In addition, the final Regulations clarify the procedures a taxpayer must follow to revoke this election. This removes some of the flexibility for obtaining cost recovery of non-incidental materials and supplies starting on acquisition, or spreading the cost over a longer period as permitted under the Temporary Regulations.

COSTS TO REPAIR OR IMPROVE TANGIBLE PROPERTY

As with the 2011 Regulations, the centerpiece of the final Regulations is the detailed set of rules governing the distinction between currently deductible maintenance costs and capital improvements.

While in some respects the final Regulations restate or adopt standards from the 2011 Regulations, in other respects they make significant changes of which taxpayers should be aware. Because these changes are effective for tax years beginning in 2014, and generally will require taxpayers to make accounting method changes to conform, taxpayers should begin evaluating the impact of the new rules on their present accounting methods for fixed assets as soon as possible.

The 'Unit of Property'

As has always been the case, the improvement standards are applied to the "unit of property," and the prior versions of the Regulations provided detailed rules for this purpose. The final Regulations made no changes (but only a subtle clarification) to the definition in the Temporary Regulations.

The clarification provides that in the case of leasehold improvements made by a lessee, including improvements to leasehold improvements, the unit of property is based on the general definitions of the unit of property, but with respect to the portion of the property that is subject to the lease, and not just with reference to the leasehold improvements. **14** The final Regulations also continue to indicate that reliance on issued or potential industry guidance is necessary in the case of network assets. **15**

The Three-Part 'Improvement' Test (The Capitalization Standards)

The final Regulations retain the same general framework as the 2011 Regulations and thus generally require a taxpayer to capitalize its expenditures to "improve" a pre-existing unit of property. For this purpose, a unit of property is improved if the expenditures result in (1) a betterment to, or (2) a restoration of, the unit of property, or (3) adapt the unit of property to a new or different use. **16** Taxpayers applying the capitalization standards must filter expenditures that are part of a single plan **17** through all three tests before reaching a conclusion that an expenditure is not required to be capitalized, because satisfying any one of the tests results in capitalization even if the others are not met.

Betterments. Under Reg. 1.263(a)-3(j) , an expenditure is paid for a betterment if it:

(1) Ameliorates a material condition or defect that existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property (whether or not the taxpayer was aware of the defect at the time of acquisition or production);

(2) 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

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

For a building, an amount must be capitalized if it results in a betterment to the building structure or to one

of eight enumerated building systems.

Unlike the 2011 Regulations, the final Regulations no longer phrase the betterment test in terms of expenditures that "result" in a betterment, but instead provide that capitalization is required for amounts that are "reasonably expected" to materially increase one of the listed factors. **18** The purpose of this change is to reduce controversy with respect to expenditures that span more than one tax year, where the outcome of the expenditure is uncertain at the time it is made.

Although all three standards under the betterment rule use the term "material," the final Regulations still do not provide any quantitative, bright-line tests for what is considered material for this purpose. As noted in the Preamble, Treasury and the IRS believe that bright-line tests, although objective, would produce inconsistent results given the broad array of factual settings where the betterment rules apply. Instead, the final Regulations continue to rely on qualitative factors, but in addition clarify that not every quantitative factor listed in the betterment standards apply to every type of property. Rather, the applicability of each factor to a particular unit of property depends on the nature of the unit of property. For example, the Preamble notes that the productivity and output factors would generally not apply to buildings.

To address the substantial number of comments with respect to the application of the betterment test to retail store refresh or remodel projects, although not incorporating any bright-line tests, the final Regulations do include substantially revised examples to minimize ambiguity in applying the tests to multiple simultaneous activities on a building. As revised, the examples collectively illustrate that amounts expended for items that would be classified as repairs if performed on a stand-alone basis are not required to be capitalized unless they are performed on the same physical parts of the building that are subject to a betterment and are incurred by reason of the betterment. **19** In addition, the Preamble notes that to the extent the rules in the final Regulations present situations that might be addressed through the Industry Issue Resolution (IIR) program, taxpayers may pursue additional guidance through this process.

In applying the betterment tests, the 2011 Regulations required consideration of all facts and circumstances, including the treatment of the expenditures on a taxpayer's applicable financial statement. The Preamble notes that Treasury and the IRS recognize that taxpayers may apply different standards for financial statement purposes which may not be controlling for whether the activities are considered betterments, and therefore the final Regulations have adopted one commentator's suggestion to remove the taxpayer's treatment on its financial statements as a factor to be considered.

Although the text of the betterment rule does not provide any numerical standard for what is considered a "material" condition, addition, or increase, the examples that follow are replete with numerical comparisons that taxpayers and IRS will likely rely on by analogy to determine whether other expenditures cause a "material" change to the property. For example, a 50% increase in load carrying capacity, **20** a 20%-or-above increase in harbor channel depth, **21** and a 50% reduction in energy costs **22** are considered material changes, while a 10% increase in HVAC efficiency is not. **23**

Restorations. Under **Reg. 1.263(a)-3(k)**, a taxpayer must capitalize expenditures made to restore a unit of property. For this purpose, an amount is paid to restore a unit of property only if it:

(1) Is for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under **Reg. 1.165-7**);

(2) Is for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;

(3) Is for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under **Section 165** (subject to the limitation discussed below);

(4) Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

(5) Results in the rebuilding of the unit of property to a like-new condition after the end of its class life; or

(6) Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property.

For a building, an amount is paid to restore the unit of property if it restores the building structure or one of the eight enumerated building systems.

The main changes between the 2011 Regulations and the final Regulations with respect to the restoration standards relate to the treatment of expenditures following a casualty event, and clarification of what is considered a "major component or substantial structural part."

The final Regulations retain the rule that a restoration requiring capitalization includes the replacement of an asset or portion of an asset resulting from a casualty event. Nevertheless, under the final Regulations a taxpayer is not required to treat as a restoration the amount of its post-casualty replacement expenditures that exceed the adjusted basis of the property damaged in the casualty. **24** In addition, the proposed disposition Regulations, discussed in more detail below, would make the recognition of a casualty loss mandatory and not subject to the partial disposition election.

The 2011 Regulations provided that an amount paid for the replacement of a "major component or substantial structural part" of a unit of property is an amount paid to restore (and, therefore, improve) the unit of property. The determination of whether a component or part was "major" or "substantial" depended on the facts and circumstances, including both qualitative and quantitative factors. The final Regulations add some clarification around the definition of a major component and a substantial structural part, as follows:

• The final Regulations define a *major component* as a part or combination of parts that performs a discrete and critical function in the operation of the unit of property, and a *substantial structural part* as a part or combination of parts that comprises a large portion of the physical structure of the unit of property. An incidental component (e.g., a switch) will not constitute a

major component, even though it performs a discrete and critical function.

In the case of buildings, the final Regulations provide that an amount is for the replacement of a
major component or substantial structural part if the replacement includes a part or combination
of parts that (1) comprises a major component or a significant portion of a major component of
the building structure or any building system, or (2) comprises a large portion of the physical
structure of the building structure or any building system.

The Preamble notes that, although the definition of major component for buildings introduces a new level of analysis that must be applied in determining whether an amount spent on a building constitutes a restoration, it provides an analytical framework that in combination with the addition of a routine maintenance safe harbor for buildings (discussed in more detail below), the modifications to the disposition rules, and the addition and revision of many of the examples, should relieve much of the controversy in determining whether a building expenditure results in a restoration.

As with the determination of "material" under the betterment test, the final Regulations do not provide any numerical bright-line tests for determining whether a part or combination of parts comprise a "large" portion of the physical structure of the unit of property. Similarly, in the case of buildings, the final Regulations do not provide a numerical bright-line test for whether a part or combination of parts replaces a "significant portion of" a major component of the building structure or any building system, or a "large portion of" the physical structure of the building structure or any building system. Similar to the betterment test, however, the final Regulations provide numerical examples that taxpayers will likely rely on by analogy for this purpose as well. For example:

- Replacement of 30% of HVAC units does not involve a significant portion of the major component (all HVAC units) or a large portion of the physical structure of the unit (the HVAC system). 25
- Replacement of 30% of the wiring in a building electrical system is not a significant portion of the major component (all the wiring) or a large portion of the physical structure of the unit (electrical system). 26
- Replacement of 40% of the sinks in a building does not involve a significant portion of the major component (all the sinks) or a large portion of the physical structure of the unit (the plumbing system). 27
- Replacement of 33% of the windows in a building where the windows comprise 25% of the surface area of the building does not involve a significant portion of the major component (all the windows), and the 8.25% replacement (0.25 × 0.33) does not involve a large portion of the physical structure of the unit (the building structure). 28
- Where, however, the replacement involves 67% of the windows in such a building, while the resulting 17% replacement (0.25 × 0.67) does not involve a large portion of the physical structure of the unit, it does involve a significant portion of the major component. 29
- By contrast, where the windows comprise 90% of the total surface area of the building, while 33% is still not a significant portion of the major component (all the windows), the resulting 30%

replacement (0.90 × 0.33) does involve a large portion of the physical structure. 30

- Replacing 10% of the floors in a building does not involve either a significant portion of the major component (all the floors), or a large portion of the physical structure of the building structure (the unit). 31
- On the other hand, replacing 40% of the floors in a building does involve replacement of a significant portion of the major component (all the floors). **32**
- Replacement of 25% of the elevators in a building does not involve a significant portion of a major component (as each elevator does not perform a discrete and critical function) or a large portion of the physical structure of the unit (the elevator system). 33

New or different use. Finally, under Reg. 1.263(a)-3(I), a taxpayer must capitalize amounts paid to adapt a unit of property to a new or different use.

For this purpose, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's ordinary use of the unit of property at the time it was originally placed in service by the taxpayer. For a building, an amount is paid to adapt the unit of property to a new or different use if it adapts the building structure or one of the eight enumerated building systems to a new or different use.

The final Regulations retain the substantive rules of the 2011 Regulations, but in response to comments provide additional examples that address circumstances in which part of a retail building is converted to provide new services or products. **34** Certain commentators suggested that, for specific industries, the Regulations provide that changes to facilities in response to a change in product mix, a reallocation of floor space, the need to rebrand, or the introduction of a new product line do not constitute a new or different use. The Preamble notes that tailored guidance for specific industries or types of property is not appropriate for broadly applicable guidance, but is better addressed through the IIR program; thus, the final Regulations did not incorporate this suggestion.

Routine maintenance safe harbor. The 2011 Regulations provided that the costs of performing certain routine maintenance activities for property other than a building or the structural components of a building are not required to be capitalized as an improvement. Activities were considered to be routine only if, at the time the unit of property was placed in service, the taxpayer reasonably expected to perform the activities more than once during the property's Alternative Depreciation System (ADS) class life.

The final Regulations maintain the basic requirements of the safe harbor provided in the 2011 Regulations but make changes to the types of property that are eligible for the safe harbor and clarify some of the original guidance:

- The final Regulations create a routine maintenance safe harbor for buildings, using a ten-year period as the time in which a taxpayer must reasonably expect to perform the relevant activities more than once for this type of property. **35**
- The routine maintenance safe harbor is no longer applicable to network assets. 36

- In an effort to clarify the definition of routine maintenance, the final Regulations confirm that routine maintenance can be performed any time during the life of the property provided that the activities qualify as routine under the Regulations. **37**
- Finally, the final Regulations remove the taxpayer's treatment of the activity on its applicable financial statement from the factors to be considered when determining if the taxpayer is performing routine maintenance. **38**

Treatment of removal costs clarified. The 2011 Regulations did not provide a separate rule for the treatment of removal costs, but rather addressed component removal costs as an example of a type of indirect cost that must be capitalized if the removal costs directly benefit or are incurred by reason of an improvement. The Preamble to the 2011 Regulations also noted that the rules were not intended to affect the holding of **Rev. Rul. 2000-7, 2000-1 CB 712**, as it applied to the cost of removing an entire unit of property.

Under that Ruling, a taxpayer is not required to capitalize the cost of removing a retired depreciable asset even when the retirement and removal occur in connection with the installation of a replacement asset. **Rev. Rul. 2000-7** did not explicitly state that the same rule applies when a component of an asset, rather than the entire asset, is disposed of.

The final Regulations provide that if a taxpayer disposes of a unit of property, including a partial disposition under **Prop. Reg. 1.168(i)-1(e)(2)(ix)** or **1.168(i)-8(d)**, and has taken into account the adjusted basis of the asset or a component of the asset in realizing gain or loss, then the costs of removing the unit of property or a component are not required to be capitalized as an improvement regardless of whether the replacement expenditure is a repair or an improvement. Otherwise, the treatment of the removal costs follows the treatment of the replacement expenditures, i.e., the taxpayer must deduct or capitalize the costs of removing the component based on whether the removal costs directly benefit or are incurred by reason of a repair to the unit of property, or an improvement to the unit of property. **39**

Under this clarified rule, and based on its interaction with the restoration tests, removal costs relating to a casualty event generally will be deductible since the recognition of a casualty loss results in a mandatory basis adjustment. Additionally, taxpayers should consider making a partial disposition election (as discussed in more detail below) where capitalization of a replacement is required irrespective of whether a disposition loss is taken, since this would result in the deductibility of the related removal costs.

Election to capitalize repair and maintenance costs. The final Regulations permit a taxpayer to elect to treat amounts paid during the tax year for repair and maintenance to tangible property as amounts paid to improve that property and as an asset subject to the allowance for depreciation, as long as the taxpayer incurs the amounts in carrying on a trade or business and the taxpayer treats the amounts as capital expenditures on its books and records. **40** A taxpayer that elects this treatment must apply the election to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that tax year.

The election is made by attaching a statement to the taxpayer's timely filed (including extensions) original federal tax return for the tax year in which the improvement is placed in service. Once made, the election may not be revoked.

The book conformity rule applies only to amounts capitalized during the year and does not apply to repair and maintenance costs that are expensed on the taxpayer's books and records. In other words, the IRS potentially could review items that are expensed on the books and records and determine that certain items should be treated as capital improvements for tax purposes.

Taxpayers generally will want to consider making the election to capitalize repair and maintenance expenditures, as it may reduce some of the administrative burden required to apply the capitalization standards implemented by the final Regulations. Nevertheless, a taxpayer that makes the election will be unable to subsequently treat the capitalized items as repairs by filing a method change in a later year.

ACCOUNTING AND DISPOSITION RULES FOR MACRS PROPERTY

As anticipated by **Notice 2012-73**, **2012-51 IRB 713**, Treasury and the IRS significantly revamped the rules for dispositions of property subject to **Section 168**. Due to the significant nature of the changes, the revised rules for dispositions of property were issued in proposed rather than final form, and the disposition rules in the Temporary Regulations continue to be effective for tax years 2012 and 2013. When finalized, taxpayers will also have the option to apply the revised disposition rules for 2012 and 2013-but not beyond then-because Treasury and IRS expect to finalize the Proposed Regulations before the end of 2014, so the final rules will become the only option for 2014 and beyond.

Under the proposed disposition rules, general asset accounts would cease to be the default rule for asset dispositions. Thus, taxpayers would not have to make general asset account elections in order to have flexibility with respect to the treatment of structural component dispositions.

The general asset account rules as in effect prior to the Temporary Regulations would be reinstated with some modifications. Under the Temporary Regulations, in the case of buildings, the unit of property for disposition purposes was defined to include any structural component of the building. **41** Thus, under the general rules, the recognition of a loss on the replacement of any structural component was mandatory. In part due to the administrative complexity associated with identifying the adjusted basis of individual structural components, and in part to prevent all structural component replacements from being deemed to result in restorations under the restoration rules, the Temporary Regulations allowed taxpayers who elected general asset account treatment to choose, on a disposition-by-disposition basis, either to recognize gain or loss or to continue to depreciate any asset, or structural component of an asset, in a general asset account, regardless of the reason for the disposition.

Under the reinstated general asset account rules, taxpayers who elect general asset account treatment

will no longer have this choice and will be required to continue to depreciate an asset that is disposed of from an general asset account, unless the asset is disposed of in a qualifying disposition, or the taxpayer elects to terminate the general asset account on the disposition of all the assets or the last asset in the general asset account. **42**

For this purpose, the types of dispositions that are qualifying dispositions has been narrowed to generally include only a casualty-type event, a charitable contribution, a cessation of the business, and certain nonrecognition transactions. **43** The Proposed Regulations would, however, expand the definition of the unit of property for purposes of any of these dispositions to include a portion of an entire asset (partial disposition). **44**

Partial Disposition Elections

Under the Proposed Regulations, taxpayers will no longer have to elect general asset account treatment to achieve flexibility with respect to the treatment of component dispositions. In contrast to the Temporary Regulations, the unit of property for disposition purposes is defined, in general, to consist of each item of property, taking into account all the facts and circumstances. **45** In the case of buildings, however, the Proposed Regulations explicitly provide that the unit of property generally consists of an entire building, rather than each of its structural components. **46**

In order to provide the flexibility intended by Treasury and the IRS with respect to the replacement of components, the Proposed Regulations allow taxpayers to make partial disposition elections on a disposition-by-disposition basis, whereby they could choose to recognize gain or loss when only a portion of the unit is disposed of. Unlike in the Temporary Regulations, there would be no consistency requirement with respect to the replacement of components of non-building property, and the default rule would no longer generally mandate recognition treatment on the replacement or disposition of any building structural component.

There are a few exceptions to this rule, however, where the Proposed Regulations would make it mandatory for a taxpayer to recognize gain or loss on the disposition of a portion of an entire asset. The exceptions apply if the disposition is the result of a casualty event, certain nonrecognition transactions, or a sale of a portion of the asset. **47**

Another helpful change in response to comments is that instead of making the reference point for the partial disposition election an entire asset or entire component of an asset, the partial disposition election would apply to the disposition or replacement of any portion of an asset, including a portion of a component of an asset (e.g., the replacement of a portion of a roof would be eligible for the partial disposition election). **48**

The Proposed Regulations make it easy to apply the partial disposition election. The election is made simply by claiming gain or loss on the taxpayer's timely filed (including extensions) original return for the year in which the portion of an asset is disposed of. **49** An exception to the original return requirement is

provided in the event that the IRS on exam disallows a replacement as a repair. In that case, a taxpayer may request a change in accounting method to make the partial disposition election. **50**

In addition, a transition rule is provided whereby a taxpayer may make the election for 2012 or 2013 either by filing an amended return for the year of election on or before 180 days from the extended due date of the return for that year, or by an application for change in accounting method filed with the original return for the first or second year succeeding the year of election. **51**

Identification and Basis of Disposed-of Assets

When assets are disposed of from a general asset account, a multiple asset account, or the disposition represents only a portion of an asset and the partial disposition election is made, the determination of the asset disposed of and its basis present administrative challenges for many taxpayers. While the Temporary Regulations provided that taxpayers generally may use reasonable methods for determining the adjusted basis of assets or components, the Proposed Regulations provide specific non-exclusive examples of reasonable methods for determining the adjusted basis of the asset or portion thereof that is disposed of, including:

- Discounting the cost of the replacement asset to its placed-in-service date using the Consumer Price Index;
- A pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed-of portion in proportion to the replacement cost of the entire asset; and
- A study allocating the cost of the asset to its individual components. 52

Partial Relief From the Casualty Loss Rule

As discussed above, the final Regulations retain the rule that a restoration requiring capitalization includes the replacement of an asset or portion of an asset resulting from any casualty if the taxpayer has claimed a casualty loss. In addition, the Proposed Regulations would make the recognition of a casualty loss mandatory and not subject to the partial disposition election. Nevertheless, to provide relief in situations where the taxpayer has little basis remaining in the property subject to the casualty event, the final Regulations limit the amount capitalized under the casualty loss rule to the amount of the adjusted basis of the property that is subject to the loss. **53** Amounts in excess of the limitation are not deemed to be a restoration under the casualty loss rule, but may be capitalized if they result in a betterment, adaptation, or other type of restoration. **54**

TRANSITION RULES

Changes to comply with the final Regulations and Proposed Regulations are generally to be treated as a change in method of accounting to which the provisions of **Section 446(e)** apply, and generally a

Section 481(a) adjustment will be required to make these changes. Certain provisions, including most of the elective methods, are to be implemented only with respect to amounts paid or incurred in tax years beginning after 2011, and the Regulations also provide taxpayers with the flexibility to make many of the elective methods on an annual basis for costs paid or incurred (or dispositions made) during each year. Once elected for a particular year, however, the elected treatment is revocable only with the Service's consent.

As noted at the outset, the final Regulations generally are effective for tax years beginning after 2013, but taxpayers may choose to apply them to tax years beginning after 2011. As the 2011 Temporary Regulations remain in effect for 2012 and 2013, taxpayers have three options for those years:

- (1) To apply the law in effect prior to the Temporary Regulations;
- (2) To apply the Temporary Regulations; or
- (3) To apply the final Regulations.

The choice is apparently not all-or-nothing, but rather subsection by subsection. For example, a taxpayer could apply its interpretation of pre-existing law for purposes of defining the unit of property for 2012 and/or 2013, while adopting the routine maintenance safe harbor in the final Regulations, including its expansion to buildings for those years. The Preamble also notes that the disposition Proposed Regulations are expected to be issued in final form early enough to be effective for 2014.

In those situations in which a **Section 481(a)** adjustment is required, the Regulations did not adopt suggestions to provide for extrapolation procedures to be used for prior years. The general IRS-permitted procedures for statistical sampling may be used for this purpose, however. **55** These may be used to calculate the adjustment for prior years where data may not be readily available.

Based on informal comments from Treasury and IRS officials, the transition Revenue Procedures for the final and Proposed Regulations will likely waive the general scope restrictions in **Rev. Proc. 2011-14**, **2011-4 IRB 330**, will be more streamlined than the procedures to implement the Temporary Regulations, and clarify the conditions imposed by these procedures for strict compliance with **Section 263A**. Exhibit 2 summarizes the transition methods available under the final and Proposed Regulations.

In the transition guidance accompanying the Temporary Regulations, **56** taxpayers were given a two-year transition window in which to make fully retroactive general asset account elections. These retroactive elections were permitted because the general principles in the repair Regulations were generally applied with a **Section 481(a)** adjustment, and the mandatory requirement to recognize gains and losses on component dispositions under the default rules would otherwise have made it necessary for taxpayers to compute and recognize the cumulative effect from these dispositions for all prior tax years under **Section 481(a)**. While the recognition of gains and losses on partial dispositions resulting from ordinary maintenance and improvement activities is no longer mandatory, fully retroactive transition relief would still seem necessary to achieve the Regulations' objective of avoiding overcapitalization with respect to prior-year replacement activities (e.g., replacement of an entire roof is required to be capitalized even though the taxpayer must continue to depreciate the cost of the pre-existing roof). It would be reasonable

to anticipate that the transition guidance for the Proposed Regulations will provide a similar window in which to make fully retroactive partial disposition elections.

CONCLUSION

Most of the differences between the Temporary and final Regulations for the capitalization of costs with respect to tangible property respond directly to comments from taxpayers. The changes either will provide taxpayers with a rule that will allow more current expensing (such as the routine maintenance safe harbor), or will reduce administrative complexity (such as the election to capitalize repair and maintenance costs), or both (such as the de minimis safe harbor).

The main exception to this is the new general limitation on the election to capitalize materials and supplies unless they are rotable, temporary, or emergency standby parts. This limitation may require an unanticipated change in treatment that would not have been required under the rule in the Temporary Regulations.

With respect to the improvements standards, including the unit of property, very few changes were made, and the final Regulations continue the overall facts and circumstances approach of the Temporary Regulations without numerical bright-line tests for determining whether an expenditure is a betterment or restoration, including whether a replacement involves a major component or substantial structural part. At the same time, many of the examples, which state conclusions with respect to numerical information about materiality and significance, will serve as general guidelines for taxpayers who need to apply the facts and circumstances analysis. In the final Regulations, Treasury and the IRS also responded to requests to clarify with examples when otherwise deductible repair costs are subject to capitalization under the rules of **Section 263A**.

The proposed disposition rules will likely be seen as a vast improvement from the Temporary Regulations by permitting partial dispositions of property without the need for a general assert account election, and going forward the general asset account rules will function as they were originally intended-by generally disregarding most dispositions except in special cases. The concept of a partial disposition also is no longer tied to discrete components, so there is no need for taxpayers to have a consistent and separate unit of property for disposition purposes in order to make a partial disposition election.

While the detailed procedures for implementing the final and Proposed Regulations have yet to be issued, they are expected to be released soon and will likely provide additional options, streamline the procedures, and reduce the number of different changes that will be necessary compared with the guidance originally issued under the 2011 Regulations by providing blanket consent to comply with the Regulations, rather than section-by-section specific procedures.

Taxpayers will soon have to decide whether to implement the final Regulations in 2012, 2013, or 2014, and which set of rules to implement in 2012 or 2013 if a change is made for those years. In any event, the moratorium on IRS examinations of the repairs and disposition issues, originally covering 2012 and 2013,

57 will end with 2014, **58** so most taxpayers will conclude that implementation of accounting method changes is required for 2014 at the latest if they decline the option to apply the Regulations early.

Exhibit 1. Final/Proposed Regulations Compared With Temporary Regulations

Key changes from the Temporary Regulations issued 12/27/11 made by **TD 9636** and REG-110732-13 are summarized below.

	2011 Temporary Regulations	2013 Final and Proposed Regulations
General effective dates	o May apply to tax years or in some cases, amounts paid or incurred) begin- ning after 2011 and before 2014	(or in some cases, amounts paid or incurred) begin-
		o May apply to tax years (or in some cases, amounts paid or incurred) begin- ning after 2011
Materials and Supplies		
Definition	Tangible property used by the taxpayer that is: o A component acquired to maintain, repair, or improve a unit of property (UOP)	
	 o A UOP that costs \$100 or less o A UOP with a useful life of 12 months or less o Fuel, water, lubricants, etc. o Identified as materials and supplies in other IRS guidance 	less
Timing of deduction	A taxpayer may deduct the costs of: o Incidental materials	Similar rules to the Temp. Regs.

Election to capitalize/ depreciate	<pre>and supplies when purchased o Non-incidental materials and supplies when used or consumed o Rotable or temporary spare parts when disposed of An election to capitalize and depreciate can be made for any materials and supplies</pre>	An election to capitalize and depreciate (subject to limitations) may only be made for rotable, temporary, or standby emergency spare parts
Acquisition Costs		
De minimis safe harbor amortization		item (\$500 for taxpayers without an AFS) o The taxpayer files an ion statement
Transaction costs	Costs that facilitate the acquisition must be capitalized	Similar rules to the Temp. Regs. Clarified that con- tingency fees must be in- cluded in the basis of the property acquired and may not be allocated to the property not acquired
Amounts paid to improve tangible		

property

UOP	General rulefunctional interdependence Special rules for: o Buildings o Plant property o Network assets	Similar rules to the Temp. Regs. Clarified that lease- hold improvements should be treated as if the property was owned.			
Capitaliza- tion standards: Betterment	<pre>Betterment to the UOP: o Material condition or defect at acquisition or production o Material addition or expansion o Material increase in: o Quality o Capacity o Productivity o Efficiency, or o Strength</pre>	<pre>Similar rules to the Temp. Regs. Updates included: o Clarified and modified examples o Clarification of better- ment standards for retail refreshes</pre>			
Capitaliza- tion standards: Adaptation	Adaptation of the UOP to a new or different use	Similar rules to the Temp. Regs. Updates included: o Clarification that a partial change in use is not considered an adap- tation if consistent with the original overall use of the UOP			
Capitaliza- tion standards: Restoration	<pre>Restoration to the UOP: 0 Replacement and recogni- tion of a loss on disposed-of component 0 Gain/loss on sale of a component 0 Basis adjustment as a re- sult of a casualty loss 0 Return to former operating conditionno longer functioning 0 Rebuild the property to like-new condition after the class life 0 Replacement of major com- ponent or substantial</pre>	<pre>Similar rules to the Temp. Regs. Updates included: o Modification to the casualty loss rule o Clarification of the definitions and clear distinction between a major component and SSP: o Major component focuses on the "function" of the component in the UOP o SSP focuses on the "size" of the replacement com- ponent in relation to the UOP</pre>			

	structural part (SSP)	
Routine maintenance safe harbor	Amounts may be treated as for routine maintenance of property if: o The taxpayer reasonably expects to perform the maintenance activity on the property more than once over the property's ADS class life Not applicable to building property	<pre>Similar to Temp. Regs.' definition. o Clarified the definition of routine maintenance o Expanded the safe harbor to include building prop- erty (ten-year testing period) o No longer applicable to network assets</pre>
Election to capitalize repair and maintenance costs	Not available under the Temp. Regs.	<pre>A taxpayer may elect to capitalize amounts paid for otherwise deductible repair and maintenance if: o Incurred in the taxpayer's trade or business and o Capitalized in books and records regularly used in computing the taxpayer's income Taxpayer must file an annual election statement: o Election must be applied to all repair and maintenance costs that the taxpayer treats as capital for its books and records</pre>
Dispositions and GAAs		
Dispositions	Mandatory recognition of gain/loss on the disposition of any component of a build- ing or asset. Allowed any reasonable valuation method to determine the gain/loss from the disposition	
General	No loss recognized on the	General rules for the

asset accounts	<pre>disposition of an asset included in a GAA o The taxpayer may elect to recognize gain/loss on disposition if it results in the disposal of the last or all assets in a GAA or there is a qualify- ing disposition Expanded the definition of a qualifying disposition to include generally all dispo- sitions of assets or compo- nents of assets</pre>	the Temp. Regs. o The taxpayer may elect to recognize gain/loss on a disposition if it results in the disposal of the last or all assets in a GAA or there is a qualify- ing disposition
		o One change from pre-

qualifying events

Exhibit 2. Expected Transition Methods

	Section	Costs in-	Annual	Annual	Limited	Revocable
	481(a),	curred in	election	election	retroac-	if
	including	tax years	with	without	tive	election?
	optional	beginning	statement	statement	elections	
	applica-	after	on timely		for	
	tion to	2011	return		2012-2013	
Method	2012/2013					
Materials						
and sup-		Х				
plies in						
general						
Optional						
method	Х					

for rotables X: On Election Amended Yes to capiitem-by- return talize item filed certain Х basis in within materials year 180 days placed in from and supplies service extended due date _____ _ ____ Amounts paid to Х acquire property generally _____ _____ ___ ____ De mini-Amended No X:Amounts mis safe Х paid or return harbor incurred filed election in tax within year 180 days from extended due date _____ _ _____ ____ Election X:Amounts Amended Yes to capipaid or return talize incurred filed employee by cate- within Х compensagory in 180 days tion and the tax from exoverhead year tended due date _____ _ ____ Amounts paid to improve Х property generally _____ ____ Safe X:Amounts Amended No harbor paid or Х return

for small taxpayers Optional regulatory method	х х		incurred in the tax year		filed within 180 days from ex- tended due date	
Election to capi- talize repair costs		x	X:Amounts paid or incurred in the tax year		Amended return filed within 180 days from ex- tended due date	Yes
Disposi- tion rules generally	X					
Election to apply GAA			X:Proper- ty-by- property in year placed in service			No
Election to ter- minate GAA for qualify- ing dis- position Election to ter-				X:Proper- ty-by- property in year of dispo- sition X:Proper- ty-by-		Yes
minate GAA on disposi-				property in year of dispo-		

tion of	sition	
last asset		
Partial	X:Dispo-	Amended
disposi-	sition by	return
tion	disposi-	filed
election	tion in	within
	year of	180 days
	disposi-	from ex-
	tion	tended
		due date
		or Form
		3115 for
		disposi-
		tions in
		2012/2013

Practice Notes

The final Regulations allow a taxpayer to file an amended return up to 180 days after the extended due date of its tax return for tax years starting after 2011 and ending before 9/20/13 to make a proper election to adopt the de minimis safe harbor if the election was not made on its timely filed original return. Thus, calendar-year taxpayers that have recently filed their 2012 tax returns should analyze the impact of the changes to the de minimis safe harbor implemented by the final Regulations and consider the opportunity to file an amended return within the 180-day window. A taxpayer cannot amend, however, if it did not have a written policy in place at the beginning of the tax year.

1

REG-110732-13, 9/19/13.

2

See REG-168745-03, 8/21/06 (the "2006 Proposed Regulations"), REG-168745-03, 3/7/08 (the "2008 Proposed Regulations"), and **TD 9564**, 12/27/11 (the "2011 Regulations").

3

For a discussion and analysis of the 2006 and 2008 Proposed Regulations, and 2011 Regulations, see Conjura, Atkinson, Afeman, and Fitzpatrick, "Repairs vs. Capital Improvements: New Temp. Regs. Clarify the Distinction and Require Accounting Method Changes," **116 JTAX 124 (March 2012)**; Conjura, Kreutzer, and Culp, "IRS 'Repairs' the Regs. for Distinguishing Deductible Repairs From Capital Improvements," **108 JTAX 196 (April 2008)**; and Conjura, Culp, and Fitzpatrick, "Are the Prop. Regs. the Right Fix for the Treatment of Repair and Improvement Costs?," **105 JTAX 261 (November 2006)**.

4

Also, **Reg. 1.263(a)-1(e)(2)** provides that while in general costs that facilitate the sale of property are taken into account in computing gain or loss, such costs incurred by a dealer are currently deductible. This is a favorable timing result in those cases where the dealer is able to report gain on the installment method (timeshares and undeveloped lots). See Section 453(I)(2).

5

Reg. 1.263(a)-2(f)(2)(iv)(A) .

6

See, e.g., Peco Foods, Inc., **TC Memo 2012-18**, RIA TC Memo ¶2012-018, *aff'd* 522 Fed Appx 840, **112 AFTR 2d 2013-5137** (CA-11, 2013).

7

This second exception mirrors the exception in the intangibles Regulations and affirms that the government will not attempt to apply principles similar to **Section 263A** to the acquisition of tangible property.

8

Reg. 1.263(a)-1(f)(1)(i). This amount is limited to \$500 per invoice or item for taxpayers without an applicable financial statement.

9

Temp. Reg. 1.263(a)-2T(g)(3).

10

Regs. 1.263(a)-1(f)(3)(v) and 1.263(a)-1(f)(7), Example 10.

11

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Reg. 1.162-3(c)(1).
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12

Reg. 1.162-3(a).

13

Reg. 1.162-3(d). If the materials and supplies are rotable or temporary, the taxpayer may use the optional method whereby the taxpayer would deduct the cost of the replacement item when put in service, and capitalize the cost of repairing the broken item as a new supply. Further, unless the de minimis rule applies, materials and supplies used for a self-constructed asset, or improvement thereto, or to produce or resell inventory, must be capitalized under **Section 263A** to the property produced or acquired for resale in the year otherwise deducted under the rules of **Reg. 1.162-3**.

Reg. 1.263(a)-3(e)(2)(v)(B)(2) .

15

Preamble to TD 9636 , 9/19/13.

16

Reg. 1.263(a)-3(d) .

17

Reg. 1.263(a)-3(g)(1)(i). The requirement to aggregate costs that are part of a single plan applies even if the expenditures cross over one or more tax years. See **Regs. 1.263(a)-3(g)(3)** and **1.263(a)-3(k)(7)**, **Example 24**, involving the replacement of a major component or substantial structural part. Expenditures incurred over a three-year period were evaluated to determine that replacement of plumbing fixtures involved replacement of a major component and substantial structural part.

18

Reg. 1.263(a)-3(j)(1)(iii) .

19

Compare Examples 6, 7, and 8 in Temp. Reg. 1.263(a)-3T(h)(4) with Examples 6, 7, and 8 in final **Reg.** 1.263(a)-3(j)(3).

20

Reg. 1.263(a)-3(j)(3), Example 14.

21

Id., Example 17.

22

Id., Example 21.

23

Id., Example 19.

24

Reg. 1.263(a)-3(k)(4). As the rule provides and examples illustrate, however, this limitation determines only the amount that is treated as a restoration under the so-called "casualty loss rule." It does not put any limit on what may have to be capitalized under the betterment or other restoration rules, including the major component test.

25

Reg. 1.263(a)-3(k)(7), Example 16.

26

Id., Example 21.

27

Id., Example 23.

28

Id., Example 25.

29

Id., Example 26.

30

Id., Example 27.

31

Id., Example 28.

32

Id., Example 29.

33

Id., Example 30.

34

Reg. 1.263(a)-3(l)(3), Examples 5 and 6.

35

Reg. 1.263(a)-3(i)(1)(i) .

36

Reg. 1.263(a)-3(i)(3)(vii) .

37

Reg. 1.263(a)-3(i)(1)(ii) .

38

Preamble to TD 9636 .

39

Reg. 1.263(a)-3(g)(2)(i) .

40

Reg. 1.263(a)-3(n) .

41

Temp. Reg. 1.168(i)-1T(e)(1).

42

Prop. Reg. 1.168(i)-1(e)(2).

43

Prop. Reg. 1.168(i)-1(e)(3)(iii)(B) .

44

Prop. Reg. 1.168(i)-1(e)(3)(i)(B) .

45

Prop. Reg. 1.168(i)-8(c)(4)(i) .

46

Prop. Reg. 1.168(i)-8(c)(4)(ii)(A) .

47

Prop. Reg. 1.168(i)-8(d)(1).

48

Prop. Reg. 1.168(i)-8(d)(2)(i) .

49

Prop. Reg. 1.168(i)-8(d)(2)(ii) .

50

Prop. Reg. 1.168(i)-8(d)(2)(iii) .

51

Prop. Reg. 1.168(i)-8(d)(2)(iv) .

52

Prop. Regs. 1.168(i)-1(j)(3) and 1.168(i)-8(f)(2).

53

Reg. 1.263(a)-3(k)(4)(i) .

54

Reg. 1.263(a)-3(k)(4)(ii) .

55

See Rev. Proc. 2011-42, 2011-37 IRB 318 . See generally Shop Talk, "New Revenue Procedure on

Statistical Sampling," 115 JTAX 239 (October 2011) .

56

Rev. Proc. 2012-20, 2012-14 IRB 700 . See Conjura, "'Repairs' Transition Guidance Provides Relief and Many Options," 116 JTAX 189 (April 2012) .

57

LB&I-4-0312-004.

58

LB&I-04-0313-001.

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