# The 2011 'Repair Regulations': A Detailed Look

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Atkinson and Lucas provide a detailed summary of the temporary and proposed IRS regulations on the taxation of costs incurred to acquire, repair, or improve tangible property. They note that the so-called repair regulations likely will apply to nearly all taxpayers, and they advise taxpayers to immediately begin considering the new regulations' impact and to identify necessary next steps.



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## I. Overview and Background

On December 27, 2011, Treasury and the IRS published in the *Federal Register* temporary and proposed regulations providing comprehensive guidance on the tax treatment of costs incurred to acquire, repair, or improve tangible property.[1] The proposed regulations amend the regulations under sections 162 and 263(a) (along with conforming changes to other regulations) and also affect the application of common-law doctrines that had developed in this area, including the so-called plan of rehabilitation doctrine. Because the regulations apply to any costs incurred to acquire, repair, or improve real or personal property, they will likely apply to nearly all taxpayers.

The temporary regulations generally are effective for tax years beginning on or after January 1, 2012. Some provisions are effective for amounts paid or incurred to acquire or produce property in tax years beginning on or after January 1, 2012. Because the guidance was issued in the form of temporary regulations, it has the same binding effect as would final regulations. As such, taxpayers must immediately consider the extent to which the new standards require a change in their current accounting practices for costs paid or incurred to acquire, maintain, or improve tangible property. When no

[1]T.D. 9564, 76 *Fed. Reg.* 81060, *Doc 2011-27005*, *2011 TNT 248-3*.

change is required, taxpayers nonetheless should immediately consider the extent to which the new standards permit a more advantageous accounting practice for some or all of their tangible property than has been applied under prior law.

Nearly all changes made to conform to the new standards will require a change in accounting method. The IRS is expected to soon issue supplementary guidance in the form of revenue procedures setting forth the transition rules for those method changes.

In general, the temporary regulations follow the same overall structure as two earlier sets of proposed regulations issued in 2006[2] and 2008.[3] The structure follows this basic framework:

- amounts paid for materials and supplies[4];
- costs to acquire tangible property[5]; and
- costs to maintain or improve tangible property.[6]

In addition to these major areas, the 2011 temporary regulations also include significant guidance modifying the application of the depreciation rules under the modified accelerated cost recovery system of section 168. These changes include the ability to immediately recover the remaining tax basis of building components (such as roofs) that are retired or replaced. This marks a fundamental change from prior law and one that will benefit most taxpayers undertaking capital improvements.

## II. Materials and Supplies

New reg. section 1.162-3T follows prior law by providing that amounts paid to acquire or produce ''non-incidental'' materials and supplies are deductible in the year in which the materials and supplies are used or consumed in the taxpayer's operations. Also as under prior law, reg. section 1.162-3T provides that amounts paid to acquire or produce ''incidental'' materials and supplies are deductible in the year in which those amounts are paid, provided taxable income is clearly reflected. For this purpose, incidental materials or supplies are those that are carried on hand and for which no record of consumption is kept or of which the taxpayer does not conduct an inventory at either the beginning or end of the year. As with all the costs governed by the temporary regulations, the potential application of section 263A must always be considered separately.

Because the deductibility of materials and supplies differs from other forms of personal property acquired by the taxpayer (the costs of which normally are deductible when the item is acquired or else capitalized and depreciated), the definition of materials and supplies is important. The temporary regulations provide significantly more guidance than had been available under prior law. Under reg. section 1.162-3T(c), ''materials and supplies'' means tangible property that is used or consumed in the taxpayer's operations, that (1) is not inventory and (2) falls into one of the following categories:

- is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property;
- consists of fuel, lubricants, water, and similar items, that are reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations;
- is a unit of property (as determined under the standards discussed below) that has an *economic useful life* of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;
- is a unit of property that has an acquisition or production cost (as determined under section 263A) of $100 or less (or another amount identified in future guidance published in the *Federal Register* or the Internal Revenue Bulletin); or
- is identified in guidance published in the *Federal Register* or the IRB as materials and supplies within the scope of this regulation.

In applying the third standard (economic useful life of 12 months or less), the property's economic useful life is the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or for the production of income.[7] The economic useful life is not necessarily the useful life inherent in the property. For taxpayers with an applicable financial statement (AFS) (such as SEC filings, audited financial statements, or financial statements other than a tax return required to be filed with a federal or state entity other than the IRS or SEC), the economic useful life of a unit of property (for purposes of this rule only) is the useful life initially used by the taxpayer for purposes of determining depreciation in its AFS, regardless of salvage value.

[2]71 *Fed. Reg*. 48950, *Doc 2006-15723*, *2006 TNT 161-2* (the 2006 proposed regulations).

[3]73 *Fed. Reg*. 12838, *Doc 2008-5039*, *2008 TNT 47-17* (the 2008 proposed regulations).

[4]Reg. section 1.162-3T.

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

[6]Reg. section 1.263(a)-3T.

[7]Reg. section 1.162-3T(c)(3).

The temporary regulations offer two alternative accounting methods for materials and supplies (including rotable and temporary spare parts, discussed below).

### A. Election to Capitalize

First, in lieu of the general rule of deducting the costs of non-incidental materials and supplies only when they are used or consumed, taxpayers instead may elect to capitalize and depreciate costs incurred to acquire materials and supplies.[8] Taxpayers may cherry-pick the specific materials and supplies acquired during the year to which the capitalization election will apply. For example, the taxpayer could elect to capitalize and begin depreciating only the costs of specific rotable spare parts that the taxpayer anticipates will be used for a period exceeding that part's applicable depreciable life.

The election to capitalize the costs of materials and supplies is inapplicable to two types of property, however. First, it is inapplicable to amounts paid to acquire a material and supply that is intended to be used as a component of another material and supply (other than materials and supplies acquired to maintain, repair, or improve a unit of property, or fuels, lubricants, water, and similar items) if the taxpayer has not elected to capitalize the costs of the larger unit of materials and supplies. Second, the capitalization election does not apply to any amount paid to acquire or produce a rotable or temporary spare part if the taxpayer has elected to apply the optional method of accounting for rotable or temporary spare parts. If the optional method for rotables is elected, it must be applied to *all* rotable and temporary spare parts acquired within a trade or business, thereby making the election to capitalize and depreciate some of these items unavailable.

No specific form or statement is required to make this election. A taxpayer makes the election by capitalizing and beginning to depreciate the asset on the taxpayer's timely filed original federal income tax return (including extensions) for the tax year the asset is placed in service. Thus, taxpayers must ensure that they not only capitalize the expenditures in the year of purchase but that they also properly begin depreciating the property in the year it was placed in service. Failure to do so may invalidate the election. Even though it constitutes a method of accounting for the specific items for which it is made, the election may be revoked only by obtaining a private letter ruling from the IRS National Office and not by filing an amended return or a request for an accounting method change.[9]

This election might be particularly attractive for companies that anticipate using rotable or temporary spare parts in their business operations for a period that is expected to be longer than the applicable depreciable life of the asset (that is, the costs will be recovered faster through depreciation rather than waiting until the rotable or temporary part is ''disposed of'').

### B. De Minimis Rule

Second, as discussed below, the temporary regulations provide a book-conformity de minimis rule permitting a current deduction for amounts costing in the aggregate less than a prescribed ceiling. There is no ''per item'' cap on these deductions (for example, items costing less than $100 each). In a significant change to prior law, this de minimis rule may now be applied to the purchase of materials and supplies.[10] If elected, the de minimis rule rather than the ''used or consumed'' rule generally applicable to materials and supplies will govern the timing of the deduction.

Whereas the de minimis rule generally applies automatically to eligible property unless the taxpayer elects otherwise, the taxpayer must make an affirmative election to apply the de minimis rule to materials and supplies.[11] Absent an election, the costs of materials and supplies are deductible when they are used or consumed under reg. section 1.162-3T. The need to affirmatively elect this treatment is something of a misnomer, however, because no form or statement is required to make the election. Instead, the election is made by deducting the amounts paid to acquire or produce a material or supply in the tax year that the amounts are paid and complying with the requirements for applying the de minimis rule generally (discussed below). The election must be made on the timely filed (including extensions) federal income tax return for the tax year in which amounts are paid for the materials and supplies. The election may be revoked only by obtaining a private letter ruling from the IRS National Office and not by filing either an amended return or a request for an accounting method change.

Taxpayers may cherry-pick the materials and supplies to which the de minimis rule will apply, and apply the ''used or consumed'' general rule to its other materials and supplies acquired in that year. This may be an important consideration when the taxpayer's aggregate de minimis costs (including items other than materials and supplies) would otherwise exceed the applicable ceiling. In those

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[8]Reg. section 1.162-3T(d).

[9]Reg. section 1.162-3T(d)(3).

[10]Reg. section 1.162-3T(f).

[11]Reg. section 1.263(a)-2T(g)(5).

circumstances, this election allows the taxpayer to apply the de minimis rule selectively to materials and supplies whose cost recovery may be protracted (such as some rotables) and to apply the general ''used or consumed'' standard to materials and supplies whose costs will be recovered relatively quickly.

### C. Rotable and Temporary Spare Parts

The temporary regulations clarify that materials and supplies also include rotable and temporary spare parts that otherwise fall into one of the materials and supplies categories discussed above. Rotable spare parts are installed on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation.[12] A typical example of a rotable part is an aircraft engine, which is removed from the aircraft when maintenance is needed, replaced immediately on the aircraft with an identical engine, serviced, and then installed on a different aircraft when one of its engines requires maintenance. Components used in repairing electronic items such as computers are another common example of rotable spare parts. Because these items are held for this purpose (that is, being swapped out with functional but otherwise identical parts in the course of repairing the larger unit of property), they are not treated as being held for sale to customers and so are not inventoriable goods.[13]

Temporary spare parts are materials and supplies that are used temporarily until a new or repaired part can be installed and then are removed and stored for later (emergency or temporary) installation.[14] Typically temporary spare parts are those that not only perform a critical function, but also require a long lead time between being ordered and delivered (such that it is not practical to wait for a parts failure before obtaining a replacement part). A common example is an emergency generator or similar major component held by an electric utility for immediate installation in a power plant in the event of a parts failure that would otherwise cause a disruption of electrical service to the surrounding area.

The temporary regulations provide the taxpayer substantial flexibility in accounting for rotable and temporary spare parts. The taxpayer essentially has four options in accounting for these costs:

- deduct on final disposition;
- capitalize and depreciate;
- apply the de minimis rule; or
- apply the optional method for rotables.

Because both rotable and temporary spare parts are materials and supplies, they are subject to the general rule that their acquisition costs may be deducted when the parts are used or consumed in the taxpayer's business operations. Because of the peculiar way in which rotable or temporary parts are used in comparison with the taxpayer's ordinary materials and supplies, however, a special standard for ''used and consumed'' applies. Under this rule, rotable and temporary spare parts are used or consumed in the taxpayer's operations in the tax year in which the taxpayer *disposes* of the parts (as opposed to the year in which the part is first used).[15] This can significantly delay the taxpayer's ability to recover the costs, depending on how long the particular part will be used for the particular purpose:

> Example: Taxpayer operates a fleet of specialized vehicles that it uses in its service business. At the time it acquires a new type of vehicle, Taxpayer also acquires a substantial number of rotable spare parts that it will keep on hand to quickly replace similar parts in its vehicles as those parts break down or wear out. These rotable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles. In Year 1, Taxpayer acquires several vehicles and a number of rotable spare parts to be used as replacement parts in these vehicles. In Year 2, Taxpayer repairs several vehicles by using these rotable spare parts to replace worn or damaged parts. In Year 3, Taxpayer removes these rotable spare parts from its vehicles, repairs the parts, and reinstalls them on other similar vehicles. In Year 5, Taxpayer can no longer use the rotable parts it acquired in Year 1 and disposes of them as scrap. The rotable spare parts are materials and supplies. Rotable spare parts are generally used or consumed in the tax year in which the taxpayer disposes of the parts. Therefore, the amounts that Taxpayer paid for the rotable spare parts in Year 1 are deductible in Year 5, the tax year in which the Taxpayer disposes of the parts.[16]

[12]Reg. section 1.162-3T(c)(2).
[13]*Hewlett-Packard Co. v. United States*, 71 F.3d 398 (Fed. Cir. 1995), *Doc 95-10985*, *95 TNT 240-9*, *rev'g Apollo Computer Co. v. United States*, 32 Fed. Cl. 334 (1994), *Doc 94-10874*, *94 TNT 243-5*; *Honeywell Inc. v. Commissioner*, T.C. Memo. 1992-453, *aff'd*, 27 F.3d 571 (8th Cir. 1994), *Doc 94-6514*, *94 TNT 135-16*; Rev. Rul. 2003-37, 2003-1 C.B. 717, *Doc 2003-7509*, *2003 TNT 57-13*.
[14]Reg. section 1.162-3T(c)(2).
[15]Reg. section 1.162-3T(a)(3).
[16]Reg. section 1.162-3T(h), Example 2.

As with all materials and supplies, the taxpayer may choose instead either to capitalize and depreciate the cost of the rotables or to apply the de minimis rule to the extent it is available. The taxpayer also may choose a fourth option available only for rotable and temporary spare parts. The ''optional method for rotables and temporary spare parts''[17] is an all-or-nothing election available for all such items held by a particular trade or business, regardless of when acquired (that is, it is not an annual election, and no cherry-picking is allowed). Once made, the election can be revoked only by obtaining IRS consent through a private letter ruling, rather than through the more traditional route of filing Form 3115 for an accounting method change.

The optional method applies to costs incurred in connection with each part's initial installation, removal, repair, maintenance or improvement, reinstallation, and disposal. Under this method, the taxpayer deducts the amount paid to acquire or produce the part in the tax year that the part is first installed on a unit of property for use in the taxpayer's operation. In each tax year in which the part is removed from a unit of property, the taxpayer includes the fair market value of the rotable or temporary part in its gross income, and also adds that same amount to the rotable part's tax basis (reflecting the fact that the FMV has been taxed and so should be assigned a tax basis). The taxpayer also adds to the part's basis the amounts paid to remove the part from the unit of property. After removing the rotable part from the larger unit of property, the taxpayer is not allowed to currently deduct any amounts spent in maintaining, repairing, or improving the rotable, and instead must add those amounts to the rotable part's tax basis. When the rotable part is later reinstalled on another unit of property, the taxpayer is allowed to deduct in that year the amounts paid to reinstall the part as well as the amounts added to the rotable part's tax basis (that is, the FMV, removal costs, and costs incurred to repair or maintain the rotable after being removed), but only to the extent the same amounts have not previously been deducted. When the rotable or temporary part is eventually disposed of, the taxpayer is entitled to deduct the tax basis of the part to the extent it has not previously been deducted under this optional accounting method:

> Example: Assume the same facts in the foregoing example, except the Taxpayer uses the optional method of accounting for all of its rotable and temporary spare parts. In Year 1, X acquires several vehicles and a number of rotable spare parts (the ''Year 1 rotables'') to be used as replacement parts in these vehicles. In Year 2, the Taxpayer repairs several vehicles and uses the Year 1 rotables to replace worn or damaged parts. In Year 3, the Taxpayer pays amounts to remove these Year 1 rotables from its vehicles. In Year 4, the Taxpayer pays amounts to maintain, repair, or improve the Year 1 rotables. In Year 5, the Taxpayer pays amounts to reinstall the Year 1 rotables on other similar vehicles. In Year 8, the Taxpayer removes the Year 1 rotables from these vehicles and stores these parts for possible later use. In Year 9, the Taxpayer disposes of the Year 1 rotables. Under the optional method for rotables, the Taxpayer must deduct the amounts paid to acquire and install the Year 1 rotables in Year 2, the tax year in which the rotable spare parts are first installed by the Taxpayer in its vehicles. In Year 3, when the Taxpayer removes the Year 1 rotables from its vehicles, it must include in its gross income the fair market value of each part. Also in Year 3, the Taxpayer must include in the basis of each Year 1 rotable the fair market value of the rotable parts and the amount paid to remove them from the vehicle. In Year 4, the Taxpayer must include in the basis of each Year 1 rotable the amounts paid to repair, maintain, or improve each rotable. In Year 5, the year that the Taxpayer reinstalls the Year 1 rotables (as repaired or improved) in other vehicles, it must deduct the reinstallation costs and the amounts previously included in the basis of each part. In Year 8, the year the Taxpayer removes the Year 1 rotables from the vehicles, it must include in income the fair market value of each rotable part removed. In addition, in Year 8, it must include in the basis of each part the fair market value of that part and the amount paid to remove each rotable from the vehicle. In Year 9, the year that the Taxpayer disposes of the Year 1 rotables, it may deduct the amounts remaining in the basis of each rotable.[18]

### D. Other Considerations

When disposed of, materials and supplies may not be treated as capital assets under section 1221 nor as property used in a trade or business within the scope of section 1231. Instead, any gain or loss

[17]Reg. section 1.162-3T(e).

[18]Reg. section 1.162-3T(h), Example 3.

from the disposition of materials and supplies must be reported as ordinary gains or losses.[19]

Finally, section 263A may require capitalizing otherwise deductible materials and supply expenditures to the extent those materials and supplies are used in the production of other items. Thus, for example, even though a particular material or supply is used or consumed by the taxpayer in year 1, no deduction is permitted for the acquisition cost of those materials if they are used by the taxpayer in producing inventory to be held for sale to customers (or in producing other property subject to section 263A). Instead, those costs are treated either as direct or indirect materials costs, which must be capitalized under section 263A and recovered under the taxpayer's applicable inventory accounting method.

## III. Acquisition and Production Costs

In general, the temporary regulations do not change the long-standing rule that costs paid or incurred to either acquire or produce tangible property must be capitalized. The principal changes made in this area relate to de minimis costs and transaction costs incurred in connection with the acquisition or production of real or personal property.

### A. General Rule

The rules governing costs incurred to acquire or produce real or personal property are in reg. section 1.263(a)-2T. The general rules largely restate the rules that have appeared in the regulations for decades and make no substantive changes to the general rule. Reg. section 1.263(a)-2T(d) provides that except as specifically provided elsewhere (such as the new de minimis rule), a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. The amounts required to be capitalized include the invoice price, transaction costs, and work performed before the date the unit of property is placed in service by the taxpayer. Taxpayers also must capitalize costs paid to acquire real or personal property for resale and to produce real or personal property. Section 263A provides specific rules regarding the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

### B. Transaction Costs

Taxpayers must capitalize amounts paid to facilitate the acquisition or production of real or personal property.[20] As with the rules applicable to acquisitions of intangible assets,[21] an amount is paid to facilitate an acquisition of tangible property if it is paid "in the process of investigating or otherwise pursuing" the acquisition. This determination is made based on all the facts and circumstances of the acquisition, including whether the transaction cost would have been incurred but for the acquisition of the tangible property.

"Inherently facilitative" costs must always be capitalized. An amount is inherently facilitative if it is for:

- transporting the property (for example, shipping fees and moving costs);
- securing an appraisal or determining the value or price of property;
- negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;
- application fees, bidding costs, or similar expenses;
- preparing and reviewing the documents that effectuate the acquisition of the property;
- examining and evaluating the title of the property;
- obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;
- conveying property between the parties, including sales and transfer taxes, and title registration costs;
- finders' fees or brokers' commissions, including amounts that are contingent on the successful closing of the acquisition;
- architectural, geological, engineering, environmental, or inspection services pertaining to particular properties; or
- services provided by a qualified intermediary or other facilitator of section 1031 exchange.

Inherently facilitative costs must be capitalized even if the real or personal property to which they relate is not eventually acquired or produced. Instead, the costs must be capitalized and recovered under the applicable provision of the code (such as section 165 (abandonments), or section 167 or 168 (depreciation)). For example, if the taxpayer pays for separate appraisals on two potential building sites even though it intends to construct only one building, the costs of both appraisals must be capitalized. The appraisal costs for the real property that the taxpayer never acquires are deductible only when the taxpayer abandons that potential transaction.

[19]Reg. section 1.162-3T(g).

[20]Reg. section 1.263(a)-2T(f).

[21]Reg. section 1.263(a)-4(e) and -5(e)(2).

The temporary regulations provide an exception to capitalization for some transaction costs incurred in connection with the acquisition of real property. Under reg. section 1.263(a)-2T(f)(2)(iii), costs incurred in the process of investigating or otherwise pursuing the acquisition of real property do not facilitate the acquisition if they relate to activities performed in the process of determining whether to acquire real property and which real property to acquire. This exception reflects the ''whether and which'' standard that the IRS adopted in Rev. Rul. 99-23[22] to distinguish deductible investigative costs from capitalizable acquisition costs. Although that standard itself proved difficult to apply, Treasury and the IRS nonetheless retained it for this limited purpose in the temporary regulations. The government specifically rejected public requests to extend the same safe harbor to transaction costs incurred in investigating whether and which personal property to acquire. Note that the rule does not apply to costs incurred in connection with the production — as opposed to the acquisition — of real property. It also does not apply to inherently facilitative costs, such as the costs of the two appraisals in the foregoing example.

Because this special ''whether and which'' rule applies only to acquisitions of real property, if the investigative costs relate to the acquisition of both real and personal property, the temporary regulations require an allocation. No standard is provided for doing so, requiring only that the taxpayer make a ''reasonable'' allocation:

> Example: Taxpayer, the owner of several retail stores, decides to examine the feasibility of opening a new store in City A. In October, Year 1, Taxpayer hires and incurs costs for a development consulting firm to study City A and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that Taxpayer should consider for purposes of locating a new store. In December, Year 1, Taxpayer continues to consider whether to purchase real property in City A and which property to acquire. Taxpayer hires and incurs fees for an appraiser to perform appraisals on two different sites to determine a fair offering price for each site. Taxpayer is not required to capitalize amounts paid to the development consultant in Year 1 because the amounts relate to activities performed in the process of determining whether to acquire real property and which real property to acquire, and the amounts are not inherently facilitative costs. However, the Taxpayer must capitalize amounts paid to the appraiser in Year 1 because the appraisal costs are inherently facilitative costs. In Year 2, Taxpayer must include the appraisal costs allocable to property acquired in the basis of the property acquired and may recover the appraisal costs allocable to the property not acquired.

Again mirroring the rules applicable to acquisitions of intangibles, the temporary regulations provide safe harbors permitting a current deduction for employee compensation and overhead incurred in connection with the acquisition (but not the production) of real or personal property, even when those costs would be inherently facilitative if paid to a third party.[23] As with all the rules in the temporary regulations, however, taxpayers must consider whether the otherwise deductible amounts nonetheless must be capitalized under section 263A.

Taxpayers may instead elect to capitalize employee compensation and overhead. The election is made for each acquisition, and it applies to employee compensation, overhead, or both. The election is made by capitalizing the costs on the timely filed (with extensions) federal tax return for the year in which the costs were incurred. It can be revoked only by obtaining a private letter ruling from the IRS National Office.

### C. De Minimis Rule

The temporary regulations adopt but slightly modify the book-conformity de minimis rule proposed in 2008. Under this rule, a taxpayer is not required to capitalize an amount paid for the acquisition or production of a unit of property or of a material and supply if each of the following requirements is satisfied:

- the taxpayer has an AFS;
- the taxpayer has at the beginning of the tax year written accounting procedures treating as an expense for nontax purposes the amounts paid for property costing less than a specified dollar amount;
- the taxpayer treats the amounts paid during the tax year as an expense on its AFS in accordance with its written accounting procedures; and
- the total aggregate of amounts paid and not capitalized under the de minimis rule are less than or equal to the greater of 0.1 percent of the taxpayer's gross receipts for the tax year or 2 percent of the taxpayer's total depreciation and amortization expense for the tax year.

[22]1999-1 C.B. 998, *Doc 1999-15962*, *1999 TNT 84-39*.

[23]Reg. section 1.263(a)-2T(f)(2)(3)(iv).

This final element is not a cliff. In other words, even if the taxpayer's aggregate de minimis costs exceed this ceiling, it remains entitled to currently deduct the portion of those costs up to that ceiling. The amount over this ceiling is not currently deductible under the de minimis rule but does not otherwise affect the application of the rule. In applying this ceiling, however, any amounts paid or incurred for materials and supplies that the taxpayer elects to treat as de minimis costs under reg. section 1.162-3T(f) must be included. Also, when the taxpayer is a member of a consolidated group for federal income tax purposes, the temporary regulations are unclear whether this quantitative ceiling is computed at the consolidated group level or separately for each member of the consolidated group.

The de minimis rule does not apply to acquisitions of either land or inventory property, and as with the other rules in the temporary regulations, the taxpayer must consider the potential application of section 263A to amounts otherwise deductible under the temporary regulations.

For this purpose, an AFS is (1) a financial statement required to be filed with the SEC; (2) a certified, audited financial statement accompanied by the report of an independent CPA that is used for credit purposes, for reports to shareholders, partners, or similar persons, or for 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 agency (other than the SEC or the IRS).[24] If the taxpayer is a member of a consolidated group and its financial results are reported on the group's AFS, the group's written accounting procedures may be treated as the member's written accounting procedures in applying the de minimis rule.[25]

Taxpayers must keep in mind that the written accounting policy must be in place as of the beginning of the year. Thus, for example, unless the IRS provides transition relief in the anticipated revenue procedures, calendar-year taxpayers without those written policies in place as of January 1, 2012, will be unable to apply a de minimis rule for costs incurred in 2012. For future years, taxpayers wishing to take advantage of the de minimis rule must ensure that they have developed and have in place the required policy as of the beginning of the year in which the position is to be applied.

An important change made by the temporary regulations permits the taxpayer to deduct de minimis acquisition costs even when the acquired property is used in improvements (including materials and supplies used in improvements). As long as those costs otherwise satisfy the requirements of the de minimis rule under reg. section 1.263(a)-2T(g), they are deductible even if used in connection with making a capital improvement to another unit of property. For example, when the taxpayer purchases roofing materials to be used in connection with installing a new roof on an existing building, the costs of the roofing materials may be deducted under the de minimis rule even though they relate to an improvement to the taxpayer's building structure.

Except as applied to materials and supplies, the de minimis rule is the default rule and will apply unless the taxpayer affirmatively elects otherwise. The taxpayer may elect not to apply the de minimis rule to any or all of the property acquired during a particular tax year (that is, cherry-picking is allowed). Because the aggregate amount of de minimis costs deductible in any year is capped, taxpayers having total de minimis costs in excess of their ceiling for a given year may use this election to exclude from its de minimis costs for that year those items whose capitalized costs would be recovered over the shortest period. This preserves the extent to which the de minimis rule may be applied to immediately deduct the costs of longer-lived properties.

As with other elections available in the temporary regulations, the election to capitalize and depreciate specific units of property is made by capitalizing and beginning to recover the acquisition cost of that unit of property on the original, timely filed (including extensions) federal income tax return for the year in which the property is acquired. The election can be revoked only by obtaining a private letter ruling, rather than by filing either an amended return or a request for an accounting method change.

The preamble to the temporary regulations says that the availability of this de minimis rule is not intended to affect existing (or future) agreements between the taxpayer and its IRS examination team that, as an administrative matter, based on risk analysis or materiality, the IRS examination agents will not review specific items. The preamble notes that IRS examination teams are not now expected to revise their materiality thresholds in accordance with the de minimis rule ceiling. If a taxpayer seeks to deduct amounts that exceed both the de minimis ceiling available in the temporary regulations as well as the amount agreed on with its examination

[24]Reg. section 1.263(a)-2T(g)(6).
[25]Reg. section 1.263(a)-2T(g)(7).

team, however, the taxpayer will have the burden of showing that the treatment clearly reflects income.[26]

## IV. Maintaining/Improving Tangible Property

By far the most significant changes made by the temporary regulations to existing capitalization standards relate to costs incurred to repair, maintain, or improve tangible property. For this reason the regulations are sometimes referred to as the "repair regulations" despite being more broadly applicable.

Among the more significant changes made by the repair regulations to current law are:

- a definition of unit of property;
- changes in the capitalization standard, with specific standards for determining when an expenditure results in a betterment, a restoration, or the adaptation of a unit of property to a new or different use; and
- several new safe harbors and optional simplified methods for determining whether an expenditure must be capitalized under section 263(a).

As has been emphasized elsewhere in this discussion, however, the potential application of section 263A must always be considered, regardless of the outcome of applying the section 263(a) standards to a particular expenditure.

### A. Unit of Property

The linchpin in determining whether an expenditure must be capitalized as an improvement or may be deducted as a repair is first identifying the relevant unit of property. Previously, neither the code nor regulations defined "unit of property" for purposes of section 263(a). Although "unit of property" was defined for purposes of the interest capitalization rules of section 263A(f), the IRS frequently declined to accept this definition for purposes of section 263(a). Instead, taxpayers generally were left to struggle with the largely factual, case-by-case approach applied by the courts.

In the 2006 proposed regulations, Treasury and the IRS proposed a definition of unit of property that borrowed heavily from the factors developed by the courts, at least for personal property. Some types of personal property (such as personal property owned by regulated entities and so-called network assets such as railroad tracks and pipelines) had either a different definition of unit of property or no definition at all. Buildings generally were treated as a single unit of property. In light of public criticism of this proposed standard, in 2008 Treasury and the IRS proposed a different definition of unit of property for most types of personal property. The re-proposed standard relied more heavily on the functional interdependence test used for interest capitalization purposes. Network assets were again excluded from this definition, and a new category — "plant property" — was proposed for some types of assets (such as generating plants and assembly lines) used in an industrial process. Buildings again were treated as a single unit of property.

The temporary regulations issued in December 2011 largely adopt the definition of unit of property proposed in 2008; however, as discussed below, they significantly modify how the capitalization standards are applied to building property. As with earlier proposals, the definition of unit of property is broken down into discrete categories of property. Under the general rule, the unit of property is determined under the functional interdependence test discussed below. However, the functional interdependence standard does not apply to a building, network assets, leased property, or an improvement to property.

### B. General Rule: Functional Interdependence

Unless a separate standard is provided, the unit of property generally is determined using the functional interdependence standard. Under this standard, for real or personal property other than buildings, all the components that are functionally interdependent make up a single unit of property. Two or more components of property are functionally interdependent if the taxpayer must place each of them in service at the same time for them to perform their intended functions. For example, a computer and a printer constitute two units of property because either could have been placed in service without the other.[27] However, because the engine, generators, batteries, and trucks of a railroad locomotive are all functionally interdependent, the railroad locomotive is a single unit of property.[28]

### C. Plant Property

Plant property means functionally interdependent machinery or equipment, other than network assets (discussed below), used to perform an industrial process.[29] The regulations define "industrial process" by example to include manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities.

The temporary regulations require the taxpayer to further divide plant property into smaller units

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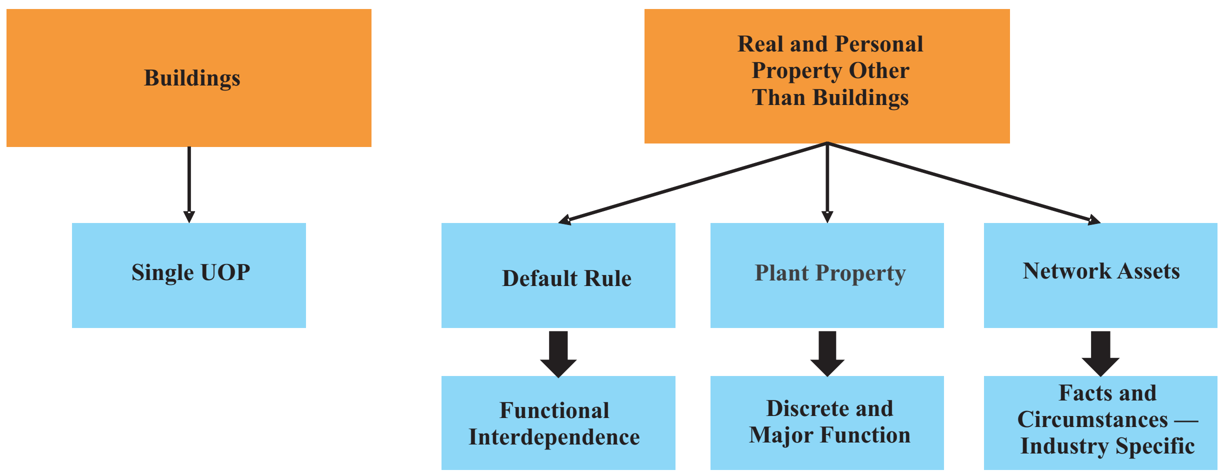
[26]76 *Fed. Reg.* at 81064-81065.

[27]Reg. section 1.263(a)-3T(e)(6), Example 9.
[28]Reg. section 1.263(a)-3T(e)(6), Example 8.
[29]Reg. section 1.263(a)-3T(e)(3)(ii).

Figure 1




made up of each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment. The regulations do not define "discrete and major function," but they do provide several examples to demonstrate the concept. For example, an electric generating facility is treated as plant property. Even though the entire power plant is a single functionally interdependent unit, it must be further divided into those components performing discrete and major functions or operations. The regulations conclude that the building structure, the boiler, the turbine, and the generator are each separate units of property, and that each of four pulverizers also are separate units of property because each performs a discrete and major function within the power plant.[30]

The regulations provide a similar example involving a uniform and linen rental business that operates many different machines and equipment in an assembly-line-like process to treat, launder, and prepare rental items for customers. The example concludes that because the equipment is property other than a building, the unit of property for the laundry equipment first is determined under the functional interdependence standard. Under this rule, the entire laundering line is a single unit because it comprises components that are functionally interdependent. Because the line is composed of plant property, however, the regulations conclude that the assembly-line-like facility must be further divided into smaller units of property that perform discrete and major functions within the line. The regulations conclude that based on the facts posited in the example, each sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system in the line is a separate unit of property because each of those components performs a discrete and major function within the larger, functionally interdependent unit.[31]

However, the regulations conclude that a restaurant's tortilla-making equipment is not plant equipment even though it uses an assembly-line-like process to prepare and cook tortillas. After applying the functional interdependence standard to treat the entire line as a single unit of property, the regulations conclude that the unit need not be further divided into smaller units. The tortilla-making equipment performs a small-scale function in the taxpayer's retail restaurant operation, rather than being used in an industrial process, and so is not plant property.[32]

Because the regulations rely on fact-based examples rather than objective criteria to distinguish an industrial process from a nonindustrial process, and again to divide the functionally interdependent unit into smaller units based on discrete and major function, this represents an area of potential disagreement between taxpayers and IRS examination teams.

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[30]Reg. section 1.263(a)-3T(e)(6), Example 5.

[31]Reg. section 1.263(a)-3T(e)(6), Example 6.
[32]Reg. section 1.263(a)-3T(e)(6), Example 7.

### D. Network Assets

The functional interdependence standard also does not apply to network assets.[33] The term ''network asset'' means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in those respective industries. Because of the tremendous differences in the nature of these various assets, including the maintenance practices used for each of them, Treasury and the IRS previously refused to even propose a single definition of unit of property applicable to all network assets. The 2006 and 2008 regulations reserved entirely on this standard, stating instead that industry specific guidance would be developed separate from the regulations. The IRS carried through with that approach by issuing revenue procedures in 2011 providing definitions of units of property for network assets used in the telecommunications[34] and electric utility[35] industries. Additional guidance for other industries is expected to follow. The IRS previously had issued a safe harbor for use by railroads in determining the deductibility of track maintenance costs.[36]

Unlike the 2006 and 2008 proposed regulations, the 2011 temporary regulations provide as an operative rule that the unit of property for network assets will be determined by the taxpayer's particular facts and circumstances, except as otherwise provided in the *Federal Register* (additional regulations) or the IRB (a revenue ruling or revenue procedure).[37] This would appear to require the issuance of formal guidance such as a regulation or revenue ruling to provide future industry-specific guidance. This could include guidance issued under the industry issue resolution program but not an industry director directive issued by the IRS Large Business and International Division. Because Treasury must approve any regulation, revenue ruling, or revenue procedure, this would preclude the IRS from unilaterally defining the units of property to be used in other industries. As a practical matter, however, there would be no procedural hurdle to LB&I issuing an industry director directive instructing examination teams to accept defined units of property used by particular industries.

### E. Buildings

As with the 2006 and 2008 proposed regulations, the 2011 temporary regulations retain the general rule that a building and its structural components constitute a single unit of property.[38] For this purpose, the regulations adopt the definition of the term ''building and structural improvements'' found in reg. section 1.48-1(e)(1) and (2), respectively.

The significant departure made by the temporary regulations lies not in this definition of unit of property but instead in how the regulations apply the capitalization standards discussed below in determining whether this unit of property (the building) has been improved. Whereas the capitalization standards normally are applied to the entire unit of property (that is, has the unit been bettered, restored, or its use changed), for a building the capitalization standards are applied to a smaller component of the overall unit of property — either the building structure or one of eight specific ''building systems.''[39]

If the expenditures at issue result in an improvement considering only their effect on the building structure or the specific building system affected by the expenditure, those costs are capitalized. If capitalization is required, however, the costs are capitalized to the entire building (that is, the unit of property) rather than to the smaller component that was used in applying the capitalization standard. This at least formally prevents the ''componentization'' of the building for purposes of section 263(a) while also, in the government's view, avoiding a standard that would permit current deductions for building maintenance costs in excess of those traditionally permitted by the courts.

In applying the temporary regulations, it is necessary to identify the building structure and each building system. For this purpose, the building structure consists of the building (as defined in reg. section 1.48-1(e)(1)) and its structural components (as defined in reg. section 1.48-1(e)(2)), other than structural components designated as building systems by the temporary regulations.[40]

The temporary regulations provide a list of the eight categories of building systems to be used in applying the capitalization standards:

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[33]Reg. section 1.263(a)-3T(e)(3)(iii).

[34]Rev. Proc. 2011-27, 2011-18 IRB 740, *Doc 2011-7082*, *2011 TNT 65-10* (wireline network assets); Rev. Proc. 2011-28, 2011-18 IRB 743, *Doc 2011-7081*, *2011 TNT 65-11* (wireless network assets).

[35]Rev. Proc. 2011-43, 2011-37 IRB 326, *Doc 2011-17890*, *2011 TNT 162-19*.

[36]Rev. Proc. 2001-46, 2001-2 C.B. 263, *Doc 2001-22281*, *2001 TNT 163-6*.

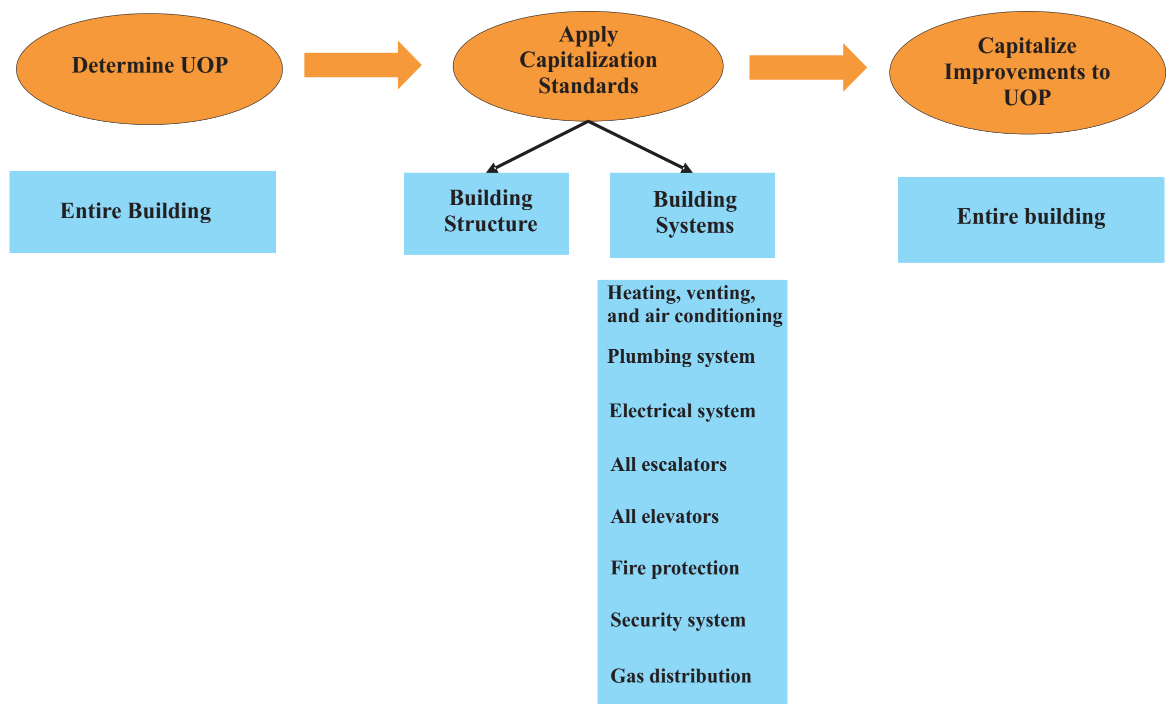
[37]Reg. section 1.263(a)-3T(e)(3)(iii)(B).

[38]Reg. section 1.263(a)-3T(e)(2).

[39]Reg. section 1.263(a)-3T(e)(2)(ii).

[40]Reg. section 1.263(a)-3T(e)(2)(ii)(A).

Figure 2




- heating, ventilation, and air conditioning (HVAC) systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, and radiators);
- plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures);
- electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from the property line and between buildings and other permanent structures);
- all escalators;
- all elevators;
- fire protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping and plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire fighting equipment, such as extinguishers and hoses);
- security systems for protection of the building and its occupants (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring, and conduit);
- gas distribution system (including associated pipes and equipment used to distribute gas to and from the property line and between buildings or permanent structures); and
- other structural components identified in published guidance in the *Federal Register* or the IRB that are specifically designated as building systems for purposes of this standard.[41]

## F. Leased Buildings

When the taxpayer is the lessee of a building, the unit of property is whatever portion of the building the taxpayer has leased.[42] When the taxpayer is the lessee of the entire building, the unit of property is the building and its structural elements. When the taxpayer is the lessee of only a portion of the building, the unit of property is the portion that the taxpayer has leased and the structural components associated with the leased components. As with the owners of buildings, the lessee applies the capitalization standard either to the building structure and the individual building systems (when it leases the

[41]Reg. section 1.263(a)-3T(e)(2)(ii)(B).
[42]Reg. section 1.263(a)-3T(e)(2)(v).

entire building) or to whatever portion of the structure and systems it has leased. Improvements made by the property's lessor, however, are treated as additional structural components of the leased property rather than as separate units of property.[43]

### G. Improvements to Property

An improvement to a unit of property (other than a lessee improvement) generally is not itself a unit of property separate from the unit of property that is being improved.[44] For example, when a taxpayer expands the floor space of an existing building, the expenditures produce a betterment to that building, but this ''improvement'' is not itself a separate unit of property for purposes of section 263(a). The costs instead are capitalized to the tax basis of the building that has been expanded. Keep in mind, however, that even though the improvement to the building is not a separate unit of property, those expenditures must be recovered over the same MACRS recovery period as the underlying property (rather than recovered over the remaining depreciable life of the property that has been improved).[45] For example, the costs incurred to materially expand the size of the building would be recovered over a new, 39-year period.

A different rule applies to lessee improvements required to be capitalized under reg. section 1.263(a)-3T(f)(ii)(A). An amount capitalized as a lessee improvement under that rule is a unit of property separate from the leased property being improved. In those situations, the lessee improvement is treated as the acquisition or production of a unit of property separate from the unit of property that is owned by and leased from the lessor. Once that lessee improvement has been constructed, however, further improvements to those elements are not themselves treated as separate units of property. Thus, a tenant's costs to build out a new retail space would be treated as costs to acquire new tangible property, but later costs to better, restore, or adapt the build-out to a new or different use would be an improvement to the existing unit of property.

### H. MACRS Conformity

Regardless of the unit of property determined under the general rules, a component (or a group of components) of a unit of property must be treated as a separate unit of property if at the time the larger unit of property is placed in service by the taxpayer, the taxpayer either:

- properly treats the larger unit of property and the component as being within different MACRS classes; or
- properly depreciates the larger unit of property and the component using different depreciation methods.[46]

For example, if at the time it purchases a new tractor-trailer, the taxpayer treats the tractor's tires as an asset separate from the tractor for depreciation purposes, it also must treat them as separate units of property in applying the capitalization standards of the temporary regulations.[47]

Importantly, the taxpayer also must conform the units of property used for capitalization purposes to smaller units of property used for depreciation purposes if after placing the property in service the taxpayer or the IRS changes the treatment of the property for depreciation purposes. For example, if as a result of a cost segregation study or an IRS audit a portion of a unit of property is properly reclassified to a MACRS class different from the MACRS class of the unit of property of which it was previously treated as a part, the reclassified portion of the property should be treated as a separate unit of property for purposes of the temporary regulations as well. Keep in mind that any changes to the unit of property used for capitalization purposes is a change in accounting method requiring IRS consent:

> Example: In Year 1, Taxpayer acquired and placed in service a building and parking lot for use in its retail operations. Taxpayer capitalized the cost of the building and the parking lot and began depreciating the building and the parking lot as nonresidential real property under section 168(e). In Year 3, the Taxpayer completed a cost segregation study under which it properly determined that the parking lot qualifies as 15-year property under section 168(e). In Year 3, the Taxpayer changed its method of accounting to use a 15-year recovery period and the 150-percent declining balance method of depreciation for the parking lot. In Year 3, the Taxpayer must treat the parking lot as a unit of property separate from the building.[48]

## V. Capitalization Standards

After identifying the appropriate unit of property, determining whether the expenditures incurred in connection with maintaining that unit

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[43]Reg. section 1.263(a)-3T(f)(1)(iii)(B).
[44]Reg. section 1.263(a)-3T(e)(4).
[45]Section 168(i)(6).
[46]Reg. section 1.263(a)-3T(e)(5).
[47]Reg. section 1.263(a)-3T(e)(6), Example 16. *See* Rev. Proc. 2002-27, 2002-1 C.B. 802, *Doc 2002-8149*, *2002 TNT 65-4*.
[48]Reg. section 1.263(a)-3T(e)(6), Example 18.

must be capitalized and recovered through depreciation depends on whether the costs result in either a betterment or a restoration to that unit of property, or adapting the unit of property to a new or different use.

### A. Betterments

The temporary regulations require the capitalization of costs that result in a betterment to a unit of property.[49] This standard essentially is a restatement of the prior standard that required capitalization of costs that materially increased the value of the property. Because that standard proved so difficult to apply for both taxpayers and the IRS, it now has been abandoned in favor of the betterment standard in the temporary regulations.[50]

Under this standard, an amount results in a betterment to a unit of property only if it:

- ameliorates a material condition or defect that either existed before the taxpayer's acquisition of the unit of property or arose during the production of the property;
- results in a material addition to the unit of property, including a physical enlargement, expansion, or extension of that unit; or
- results in a material increase in capacity, productivity, efficiency, strength, or quality of the unit of property, or the output of the unit of property.

Applying the betterment standard requires considering all the relevant facts and circumstances. There are no bright lines and no definition of material for this purpose. Among the relevant considerations are the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on the unit of property, and the taxpayer's treatment of the expenditure on its applicable financial statement. In lieu of bright-line standards for what constitutes a material addition to the unit of property's size, capacity, strength, etc., the temporary regulations provide numerous examples to be considered.

Although there are no bright-line rules, the temporary regulations do provide several important considerations. First, particularly for older property, identical replacement parts may not be available at the time of the repair or maintenance activity. Recognizing this, the regulations provide that if the taxpayer needs to replace a part that cannot practicably be replaced with the same type of part, the replacement of the part with an "improved, but comparable part" does not by itself result in a betterment to the unit of property.[51] As did the 2008 proposed regulations, the temporary regulations demonstrate this principle with a series of examples involving the replacement of wooden shingles damaged during a storm. When the wooden shingles are no longer available on the market, the regulations conclude that no betterment occurs if the taxpayer instead uses comparable asphalt shingles, even though the asphalt shingles may be stronger than the damaged wooden shingles. However, a betterment does occur if the wooden shingles instead are replaced with shingles made of lightweight composite materials that are maintenance free, do not absorb moisture, have a 50-year warranty, and have a Class A fire rating.[52]

Second, in applying the betterment standard, the temporary regulations address when to make the required comparisons.[53] In general, if the maintenance is required because of a particular event, the betterment standard is applied by comparing the condition of the property immediately after the expenditure with the property's condition immediately before the event that made the maintenance necessary. This is a restatement of the long-standing *Plainfield-Union* standard.[54] Similarly, when the maintenance is necessary because of normal wear and tear to the unit of property, the relevant comparison is with the property's condition immediately before the last time the taxpayer corrected the effects or normal wear and tear. If this is the first time the taxpayer has corrected the effects of wear and tear, the property's condition following the maintenance is compared with its condition at the time it was acquired.

In considering whether the taxpayer is correcting a preexisting defect in the property, the taxpayer's knowledge of the defect at the time of its acquisition is not relevant. Some taxpayers have asserted that if the buyer was unaware of the problem, the purchase price would not have been reduced to reflect the problem, such that currently deducting the costs would place the taxpayer in roughly the same position as if the purchase price had been discounted and the cost of correcting the problem had been capitalized by the buyer as additional purchase price. The temporary regulations reject this position, stating in the preamble that attempting to determine the buyer's subjective knowledge is not an administrable standard.[55] Thus, for example, when a taxpayer purchases land without knowing

[49]Reg. section 1.263(a)-3T(h).

[50]73 *Fed. Reg*. at 12842.

[51]Reg. section 1.263(a)-3T(h)(3)(ii).

[52]Reg. section 1.263(a)-3T(h)(4), examples 13, 14, and 15.

[53]Reg. section 1.263(a)-3T(h)(3)(iii).

[54]*Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962).

[55]76 *Fed. Reg*. at 81071.

that it contains a leaking underground storage tank, costs later incurred to remove the tank and remediate the contaminated soil nonetheless must be capitalized.[56] However, the temporary regulations conclude that removing asbestos insulation does not ameliorate a ''defect'' of a building structure.[57]

Similarly, whether the expenditures are required to bring the property into compliance with applicable laws or regulations is not relevant.[58] The relevant factor is the effect that the costs have on the property, regardless of the reason the taxpayer incurred the costs. For example, when a taxpayer is directed by health inspectors to incur costs to seal the basement of a meat processing facility to block hazardous fumes from entering the facility, the costs are deductible when they do not make the property more efficient, increase its capacity, productivity, and so on. However, when a city requires a hotel to replace masonry cornices on its exterior with otherwise identical fiberglass cornices to reduce the risk of injury in the event of an earthquake, the replacement costs must be capitalized. There, although both cornices serve the same function, the temporary regulations view the fiberglass decorations as materially increasing the building's structural soundness (that is, the strength). Capitalization is required by the nature of the activity, not by the fact that the taxpayer was required to do so to comply with city ordinances and so continue operating the hotel. Like many other aspects of the temporary regulations, this is a restatement of prior law.[59]

The treatment of costs incurred to ''refresh'' retail stores was a source of considerable discussion following the 2008 proposed regulations. Many taxpayers encountered problems with IRS examination teams that took the position that many activities incurred in periodically ''refreshening'' a store by, for example, installing updated floor surfaces, shelving, lighting, or rearranging non-structuring walls, resulted in a betterment to the store. Treasury and the IRS received a number of public comments requesting that the regulations contain greater specificity and clarification on those ''refresh'' activities that do and do not result in a betterment.[60]

Although it declined to provide more specificity in the operative rules, Treasury and the IRS did provide additional guidance in the examples demonstrating the application of the betterment standard to store ''refreshes.'' The examples posit three extensive and detailed factual scenarios. In one example, the temporary regulations conclude that the taxpayer does not ''better'' its stores when it makes cosmetic and layout changes to the stores' interiors and undertakes general repairs and maintenance to the store buildings to make the stores more attractive and the merchandise more accessible to customers. However, the temporary regulations require capitalizing these same costs when (as a factual matter) they are incurred at the same time as and are found to have ''directly benefited or were incurred by reason of'' the taxpayer also having undertaken activities that were found to be improvements to the store's building and electrical systems.[61] An intermediate example permits a current deduction for the ''refresh'' costs when they occur at the same time as, but lack a sufficient factual nexus with, other activities treated as a betterment to the store.[62]

While the examples are useful, it must be kept in mind that they demonstrate the application of an inherently factual analysis to detailed fact patterns. Taxpayers must be cautious in extrapolating the conclusions of these examples to their own particular facts. In several cases, the examples stipulate (without explanation or analysis) particular factual relationships to demonstrate a specific point, even though the stipulated relationship is not immediately apparent. For instance, one example stipulates as a factual matter than some otherwise deductible maintenance costs must be capitalized because they directly benefit or are incurred by reason of other maintenance activities, even though that stipulated relationship is questionable.[63] Thus, while these examples are an important starting point and provide useful analytical tools, taxpayers must carefully consider their own specific facts in determining how the capitalization standards apply.

### B. Relocation Costs

Costs incurred to install newly acquired property must be capitalized as a component of the acquisition costs of that property. However, costs incurred to simply move property that previously was placed in service are not required to be capitalized as a betterment to that property. Thus, for example, when the taxpayer previously purchased and installed new cash registers in its store, costs incurred to move the cash registers and reinstall them in a new store do not result in a betterment if the cash

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[56]Reg. section 1.263(a)-3T(h)(4), Example 1.

[57]Reg. section 1.263(a)-3T(h)(4), Example 2.

[58]Reg. section 1.263(a)-3T(f)(2).

[59]*See Swig Investment Co. v. United States*, 98 F.3d 1359 (Fed. Cir. 1996), *Doc 96-27729*, *96 TNT 201-48*; *Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635 (1950); Rev. Rul. 2001-4, 2001-1 C.B. 295, *Doc 2001-57*, *2000 TNT 247-5*.

[60]76 *Fed. Reg*. at 81072.

[61]Reg. section 1.263(a)-3T(h)(4), examples 6 and 8.

[62]Reg. section 1.263(a)-3T(h)(4), Example 7.

[63]Reg. section 1.263(a)-3T(h)(4), Example 8.

registers are used for the same purpose and in the same manner as they were in the former location.[64]

Yet, when a taxpayer decides to move its manufacturing equipment to a new location and upgrade some components of that equipment at the same time, the costs of disassembling and moving the machine and reinstalling it in the new location must be capitalized. On those facts, the temporary regulations conclude that the relocation and reinstallation costs directly benefit or are incurred by reason of the improvement of the machine and so must be capitalized as part of the betterment of that unit of property.[65]

**C. Restorations**

The second major category of costs required to be capitalized are those for restorations. This category essentially represents the former requirement that costs must be capitalized if they extend the useful life of the unit of property. Under this rule, a taxpayer must capitalize amounts paid to restore a unit of property, including amounts paid in making good the exhaustion for which an allowance is or has been made.[66] A restoration occurs if the expenditure:

- 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 as a casualty loss);
- 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;
- is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under section 165;
- 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;
- results in the rebuilding of the unit of property to a like-new condition after the end of its class life; or
- is for the replacement of a part or a combination of parts that constitutes a major component or a substantial structural part of a unit of property.

As with the betterment standard, determining whether a restoration has occurred is a largely factual inquiry, with the temporary regulations relying heavily on numerous detailed examples to demonstrate the various considerations that taxpayers should bear in mind. The regulations provide two standards before positing the examples, however.

First, a unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guidelines or the manufacturer's original specifications.[67] The temporary regulations are ambiguous on whether the federal regulatory guidelines or the manufacturer's original specifications are relevant only in considering whether the property has been restored to a status ''similar'' to new, rebuilt, or remanufactured, or instead whether these standards must be considered anytime the taxpayer is considering whether property has been brought to the status of new, rebuilt, or remanufactured. This grammatical distinction may prove relevant, particularly for older property (for which the manufacturer's original specifications are unavailable) that is not subject to federal regulatory guidelines.

Second, the temporary regulations provide guidance in determining whether the taxpayer has replaced a ''major component or a substantial structural part'' of a unit of property. The 2008 proposed regulations contained a standard that looked to whether the cost of the replacement equaled 50 percent or more of the replacement cost of the unit of property, or if the replacement involved 50 percent or more of the physical structure of the unit of property. Because of Treasury's concern that this standard could lead to drastically different results than those reached under existing case law,[68] the temporary regulations did not adopt this proposal, relying instead on a facts and circumstances test. Under this standard, the relevant facts and circumstances include the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property.[69] A major component or substantial structural part includes a part or combination of parts that make up a large portion of the physical structure of the unit of property or that perform a discrete and critical function in the operation of that unit of property.[70]

For example, the engine and cab of a truck are a ''part or combination of parts'' that make up a major component or substantial structural part of the tractor, and the petroleum tank of a truck's trailer constitutes a ''part or combination of parts'' that

[64]Reg. section 1.263(a)-3T(h)(4), Example 9.
[65]Reg. section 1.263(a)-3T(h)(4), Example 10.
[66]Reg. section 1.263(a)-3T(i).
[67]Reg. section 1.263(a)-3T(i)(3).
[68]76 *Fed. Reg*. at 81075.
[69]Reg. section 1.263(a)-3T(i)(4).
[70]*Id.*

make up a major component or substantial structural part of the trailer.[71] As such, their replacement would constitute a restoration of the tractor or the trailer, respectively.

Importantly, the replacement of a minor component of the unit of property, even though it might affect the function of the unit of property, generally will not by itself constitute a restoration under this standard.

### D. Repairs Following Casualty Event

One of the most controversial provisions of the 2006 and the 2008 proposed regulations requires the capitalization of any costs to address damage caused by a casualty event (fire, storm, etc.) to the extent the taxpayer has claimed a casualty loss under section 165 for that damage. As the preamble to the temporary regulations notes, many public comments objected to this per se capitalization requirement, contending that sections 165 and 263(a) have different purposes and operate independently. The temporary regulations nonetheless retained the rule proposed in 2006 and 2008. The preamble to the 2011 temporary regulations includes an exhaustive discussion of the government's legal analysis supporting its view.[72] Although this rule is likely to again receive considerable public criticism, the fact that the rule will have been adopted in a Treasury regulation promulgated through the Administrative Procedure Act's formal notice and comment rulemaking process will likely insulate the rule from being reversed judicially. The Supreme Court's 2011 decision in *Mayo*[73] will present a high (but not insurmountable) hurdle for any taxpayer seeking to invalidate this new rule.

### E. Adaptation to New or Different Use

Expenditures must be capitalized if they adapt a unit of property to a new or different use. Here, the temporary regulations essentially just restate the existing standards. Under the temporary regulations, an amount is paid to adapt a unit of property to a new or different use if the adaptation is inconsistent with the taxpayer's intended ordinary use of the unit of property at the time it was originally placed in service by the taxpayer. For buildings, this standard is applied by considering the expenditures' effect on the building structure or any of the specific building systems discussed previously. As with the other capitalization standards (betterments and restorations), the regulations largely rely on examples to establish the application of this requirement.

For example, costs incurred to convert a manufacturing facility into a new showroom must be capitalized as adapting the facility to a new or different use. However, costs of reconfiguring a building consisting of 20 retail spaces to convert three of those spaces into a single, larger space to accommodate a new tenant do not adapt the property to a new or different use where the building was designed to permit such reconfigurations.

The temporary regulations also discuss how this standard applies in the context of environmental cleanup costs. The regulations posit an example in which the taxpayer owns a parcel of land on which it previously conducted manufacturing operations. Those operations resulted in the land becoming contaminated with wastes related to the manufacturing activity. The taxpayer decides to discontinue its manufacturing operations and to sell the property to a developer who intends to use the property for residential housing. In anticipation of this sale, the taxpayer pays to clean the land to a standard that is required for the property's use for residential purposes. The taxpayer also pays to regrade the land so that it can be used for residential purposes. On these facts, the temporary regulations conclude that the taxpayer's costs to clean up wastes that were discharged in the course of its manufacturing operations do not adapt the land to a new or different use, regardless of the extent to which the land was cleaned. As a result, the temporary regulations conclude that those cleanup costs are not required to be capitalized under reg. section 1.263(a)-3T(j)(1).

Although not discussed in the temporary regulations, the taxpayer also must consider the potential application of section 263A and Rev. Rul. 2005-42,[74] which may require the environmental cleanup costs to be treated as an inventoriable cost if the taxpayer is engaged in other production activities during the year of the cleanup.

Also, the result may be different if the contamination being cleaned was present when the taxpayer acquired the property (that is, its removal constitutes a betterment because it addresses a preexisting defect in the property). Capitalizing the costs of remediating environmental contamination originally caused by the taxpayer during a prior period of ownership represents a change in the

[71] Reg. section 1.263(a)-3T(i)(5), Example 8.

[72] 76 *Fed. Reg.* at 81073.

[73] *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011), *Doc 2011-609*, *2011 TNT 8-10*.

[74] 2005-2 C.B. 67, *Doc 2005-13391*, *2005 TNT 118-14*. *See also* Rev. Rul. 2004-18, 2004-1 C.B. 509, *Doc 2004-2619*, *2004 TNT 26-11*.

government's position regarding those costs. Previously, the government permitted a current deduction for costs incurred to clean up contamination caused by the taxpayer, regardless of an intervening break in ownership.[75]

## VI. Additional Rules

### A. Routine Maintenance Safe Harbor

Under the routine maintenance safe harbor, an amount paid for routine maintenance performed on a unit of property other than a building or structural component of a building is deemed not to improve that unit of property.[76] This safe harbor applies only if:

- the taxpayer expects to perform the activity more than once over the property's ADS class life (determined under section 168(g)(2) or (3));
- the maintenance keeps (rather than puts) the property in an ordinarily efficient operating condition; and
- the need for the maintenance results from the taxpayer's own use of the property (rather than existing wear and tear from a prior owner's use).

The temporary regulations list as examples of routine maintenance the inspection, cleaning, and testing of the unit of property and the replacement of parts of the unit of property with comparable and commercially available and reasonable replacement parts. The potentially valuable safe harbor is not limited to oil changes, however. Instead, it also would extend to the replacement of substantial structural elements, as long as the taxpayer initially expected to do so at least twice during the property's ADS class life.

Keep in mind that the routine maintenance safe harbor does not apply to activities that improve the unit of property rather than keeping it in its ordinarily efficient operating condition. The safe harbor applies throughout the entire economic useful life of the property — not just during its ADS class life. As a result, particularly as the property ages and the state of the art for that type of property progresses, the taxpayer's entitlement to use new and improved standard parts to replace worn or damaged parts (as shown in the shingles example discussed earlier) will become particularly important in applying the routine maintenance safe harbor. The line between routine replacements using improved standard parts and replacements constituting ''betterments'' to the unit of property will become increasingly important as the unit of property ages.

The routine maintenance safe harbor is an important tool in ensuring the deductibility of a wide range of routine maintenance activities, regardless of whether they occur before or after the end of the unit of property's economic useful life.[77]

### B. Plan of Rehabilitation Doctrine

The judicially created ''plan of rehabilitation'' doctrine was a frequent source of controversy between taxpayers and the IRS under prior law. Courts had applied that doctrine to require capitalization when a taxpayer performed a number of maintenance activities as part of a plan to reinvigorate or restore property that had suffered significant degradation. The doctrine generally applied when the taxpayer was putting the property back into an ordinarily efficient operating condition, rather than keeping it in that condition.[78] In most cases, for example, the related activities were treated as having been part of a plan to essentially rebuild the property in lieu of purchasing a replacement.[79] Controversies frequently arose between taxpayers and IRS examination teams on when application of this standard was appropriate and which costs were required to be included within the scope of a plan of rehabilitation.

The temporary regulations have declared the plan of rehabilitation doctrine obsolete.[80] For years in which the temporary regulations are effective, the plan of rehabilitation doctrine should not be applied by either the taxpayer or IRS examination teams. Instead, the temporary regulations state that costs must be capitalized if they directly benefit or are incurred by reason of a capital activity.[81] This essentially is the same standard that is applied for purposes of section 263A.

The temporary regulations do not provide a standard for determining when costs benefit or are incurred by reason of a particular improvement. As with so many of the standards in the temporary regulations, this standard is demonstrated through examples rather than articulated in an objective or bright-line test:

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[75]TAM 9627002, *Doc 96-19322*, *96 TNT 132-16*. *See generally* James Atkinson and Dwight Mersereau, ''IRS Further Expands Capitalization Requirement for Environmental Cleanup Costs,'' BNA Daily Report for Executives, vol. 5, no. 220, pp. J-1-J-6 (Nov. 11, 2005); Atkinson, ''A Bright Line Rule Dims: Manufacturers Must Capitalize Environmental Cleanup Costs,'' 45 T.M. Memorandum No. 12 at 227 (June 14, 2004).

[76]Reg. section 1.263(a)-3T(g).

[77]Reg. section 1.263(a)-3T(g)(5), Example 2.

[78]*Moss v. Commissioner*, 831 F.2d 833 (9th Cir. 1987); *United States v. Wehrli*, 400 F.2d 686 (10th Cir. 1968); *Norwest Corp. v. Commissioner*, 108 T.C. 265 (1997), *Doc 97-11771*, *97 TNT 82-8*.

[79]*Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1 (1979); Rev. Rul. 88-57, 1988-2 C.B. 36.

[80]76 *Fed. Reg.* at 81069.

[81]Reg. section 1.263(a)-3T(f)(3).

Example: Taxpayer owns a fleet of petroleum hauling trucks. Taxpayer pays amounts to replace the existing cab, engine, and petroleum tanks of its trucks with new cabs, engines, and petroleum tanks. At the same time the engine and cab of the tractor are replaced, the Taxpayer pays amounts to paint the cab of the tractor with its company logo and to fix a broken taillight on the tractor. The Taxpayer must capitalize the amounts paid to paint the cab as part of the improvement to the tractor because these amounts directly benefit and are incurred by reason of the restoration of the cab. Amounts paid to replace the broken taillight, however, are not incurred by reason of the restoration of the tractor, nor do the amounts paid directly benefit the tractor restoration, even though the repair was performed at the same time as the restoration. As a result, the Taxpayer must capitalize the amounts paid to paint the cab but is not required to capitalize the amounts paid to repair the broken taillight.[82]

### C. Optional Regulatory Accounting Method

As did the 2008 proposed regulations, the temporary regulations allow taxpayers in some regulated industries to apply an optional accounting method in lieu of the capitalization standards otherwise applicable under section 263(a) and reg. section 1.263(a)-3T(d). The optional regulatory accounting method may be used by taxpayers subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface Transportation Board (STB). A taxpayer making this election must follow its method of accounting for regulatory accounting purposes in determining whether an amount paid improves property under section 263(a). In other words, the taxpayer must capitalize for federal income tax purposes only those amounts that are capitalized as improvements for regulatory accounting purposes. The tax treatment of the expenditure under the otherwise applicable standards of the temporary regulations (that is, betterments, restorations, change in use) are not relevant for taxpayers electing to use the regulatory accounting method, and other safe harbors (such as the de minimis rule) are unavailable. If elected, this method must be used for all of the taxpayer's tangible property that is subject to regulatory accounting rules:

Example: Taxpayer is an electric utility company that operates a power plant that generates electricity and that owns and operates network assets to transmit and distribute the electricity to its customers. The taxpayer is subject to the regulatory accounting rules of FERC, and chooses to use the regulatory accounting method. The taxpayer does not capitalize on its books and records for regulatory accounting purposes the cost of repairs and maintenance performed on its turbines or its network assets. Under the regulatory accounting method, the taxpayer must not capitalize for Federal income tax purposes amounts paid for repairs performed on its turbines or its network assets.[83]

Taxpayers in the telecommunications industry also have an optional repair allowance method for network assets available to them under Rev. Proc. 2011-27 (for wireline assets) and Rev. Proc. 2011-28 (for wireless assets). Electric utilities also have a repair allowance available for linear transmission and distribution property.[84] These taxpayers should consider the respective advantages of using the optional regulatory accounting method under the temporary regulations (which would apply to all assets subject to regulation by the FCC or FERC) or instead using the repair allowance methods available for their network assets. The relatively small units of property typically used for regulatory accounting purposes, however, may make the regulations' regulatory accounting method unattractive for many taxpayers.

### D. Structural Components Dispositions

The temporary regulations make substantial changes to the depreciation rules under section 168. As most relevant here, the changes include defining "disposition" for purposes of section 168 to include the retirement of a structural component of a building. In doing so, the temporary regulations allow the recognition of a loss on the retirement of that structural component.

Equally significant, the temporary regulations amend the rules applicable to "general asset accounts" under reg. section 1.168(i)-1. Generally, a taxpayer cannot claim a loss on the disposition of an asset from a general asset account. The regulations do permit the taxpayer to elect to recognize gain or loss on the disposition of an asset in a general asset account, however, if there has been a disposition of all assets or the last asset in a general asset account,[85] or if there has been a "qualifying disposition." Under prior law, a qualifying disposition was

[82]Reg. section 1.263(a)-3T(i)(5), Example 9.

[83]Reg. section 1.263(a)-3T(k)(4), Example 1.

[84]Rev. Proc. 2011-43.

[85]Reg. section 1.168(i)-1(e)(3)(ii).

limited to a casualty loss, a charitable contribution, the termination of a business or income-producing activity, and some other types of transactions.[86]

The temporary regulations amend the general asset account rules by expanding the definition of a qualifying disposition to allow the recognition of gain or loss on most dispositions of assets in general asset accounts.[87] Making a general asset account election thus would give the taxpayer the option of recognizing gain or loss on the dispositions of structural components of a building (rather than requiring such a loss as would be the case for property not in a general asset account).

The flexibility now available under the general asset account rules provides taxpayers an important tool in managing the recovery of basis in tangible assets that have been improved under the repair regulations. Under prior law, taxpayers frequently encountered difficulties created by the statutory requirement of section 168(i)(6) that the taxpayer depreciate the capitalized costs of an improvement over the same recovery period as the underlying asset. For example, the cost of a new roof is depreciated over a full 39 years, rather than over the remaining depreciable life of the building whose roof is replaced. This rule, combined with the taxpayer's inability to recover the basis of disposed-of structural components, resulted in situations in which, for example, taxpayers were required to begin depreciating the cost of a new roof over 39 years while continuing to recover the remaining basis of the roof that was replaced over the remainder of its own recovery period. Even though the taxpayer physically owned only a single roof at any one time, it was depreciating the costs of two and sometimes three roofs at the same time.

The temporary regulations ameliorate this harsh result by allowing the taxpayer to claim an immediate loss deduction for the remaining tax basis of the roof (or other structural component) that has been replaced. For example, when the taxpayer incurs costs to replace an existing roof that has not been fully depreciated, that disposition will now give rise to an immediate loss deduction, such that the taxpayer will be required to depreciate only the capitalized cost of the new roof.

The amended general asset account rules provide additional flexibility in other ways as well. For assets not held in a general asset account, the taxpayer *must* treat the structural element as having been disposed of.[88] The restoration standards of reg. section 1.263(a)-3T(i)(1)(i) preclude a current deduction for costs incurred to restore a unit of property when the taxpayer has properly deducted a loss for the replaced component. As a result, absent a general asset account election, the requirement to treat the replaced component as having been disposed of leaves the taxpayer with the difficult choice of either claiming the loss on the disposition and having to capitalize and depreciate the frequently much larger replacement costs over as many as 39 years, or else forgoing the loss deduction on the disposition (potentially forfeiting any remaining basis in the disposed of structural component) to currently deduct the replacement costs.

The amended general asset account provisions may provide an avenue for avoiding this dilemma. Under those rules, a taxpayer may elect whether to recognize gain or loss on the disposition of an asset in a general asset account when there is a qualifying disposition. The ability to make an election whether to recognize a loss arising on the disposition of a structural component provides the taxpayer increased flexibility in managing its fixed asset accounting.

## VII. Effective Date and Transition Rules

The new standards have been issued as temporary and proposed regulations. As temporary regulations, they have the same binding effect as final regulations. The temporary regulations generally are effective for amounts paid or incurred to acquire or produce property in tax years beginning on or after January 1, 2012. Because the regulations also were issued as proposed regulations, however, taxpayers have an opportunity to submit comments to Treasury and the IRS and to participate in a public hearing. Although they currently are effective (and binding), the regulations remain subject to further amendment before being adopted as final regulations. In accordance with section 7805(e)(2), the regulations must be finalized before December 23, 2014, or they will sunset. The government has indicated informally that it hopes to finalize the regulations by the end of 2012.

Complying with the new regulations is likely to require many taxpayers to change their current methods of accounting for repair costs. Because the regulations are now effective, taxpayers are entitled to immediately request IRS consent to do so under the applicable revenue procedures. However, because the IRS is expected to issue additional revenue procedures containing transitional rules and guidance for making any accounting method changes required by the new regulations, many taxpayers are expected to wait for publication of the new guidance before taking further steps to change their current methods.

[86]Reg. section 1.168(i)-1(e)(3)(iii).
[87]Reg. section 1.168(i)-1T(e)(3)(iii).
[88]Reg. section 1.168(i)-8T(d).

Finally, because the regulations are effective only for years beginning on or after January 1, 2012, they should have no binding effect for prior years. Neither taxpayers nor IRS examination teams, for example, may rely on any provisions of the regulations except to the extent that the regulations restate prior law. Nonetheless, it would not be unreasonable for IRS examination teams to consider the policy decisions reflected in the regulations in determining whether as an administrative matter to raise or challenge the deductibility of items for which a current deduction would be permitted by the temporary regulations.