# Deconstructing the tangible property final and re-proposed regulations

## Understanding how the new guidance may affect your company

October 2013

# Contents

# Overview

On September 13, 2013, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") issued final regulations[1] (the "Final Regulations") and re-proposed regulations[2] ("the 2013 Proposed Regulations") (collectively, the "2013 Regulations") that provide guidance with respect to the treatment of materials and supplies; capitalization of amounts paid to acquire or produce (or facilitate the acquisition or production of) tangible property; the determination of whether an expenditure with respect to tangible property is a deductible repair or must be capitalized; and dispostions of Modified Accelerated Cost Recovery System ("MACRS") property. Thus, the 2013 Regulations address a broad range of capitalization and deduction issues for expenditures related to tangible property and may likely impact taxpayers in all industries.

The 2013 Regulations are generally effective for taxable years beginning on or after January 1, 2014; however, a number of provisions are effective for amounts paid or incurred in taxable years beginning on or after January 1, 2014. Taxpayers may early adopt any or all of the provisions of the 2013 Regulations. Additionally, taxpayers may make certain elections on amended returns for taxable years beginning on or after January 1, 2012, and ending before September 19, 2013. Changes to comply with or adopt the non-elective provisions in the 2013 Regulations generally will be made through an accounting method change, most of which require the computation of an Internal Revenue Code ("IRC") § 481(a) adjustment. As of the date of publication, the government has not issued procedures for taxpayers to comply with the 2013 Regulations. This guidance is expected by early November 2013.

The 2013 Regulations retain many of the provisions included in the temporary regulations[3] issued in 2011 ("2011 Temporary Regulations"); however, there are a number of new provisions and changes from the 2011 Temporary Regulations as well as changes to pre-January 1, 2014 law. The major changes include:

- De minimis safe harbor election
- Small taxpayer safe harbor election
- Addition of a casualty loss rule to the restoration rules
- Expansion of the routine maintenance safe harbor to include repairs to buildings (and structural components thereof) and building systems
- Capitalization election
- Revisions to the disposition rules, including partial disposition election
- Changes to the general asset account rules to account for the new disposition provisions

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[1] T.D. 9636.

[2] REG 110732-13.

[3] T.D. 9564.

- Expanded and updated examples clarifying the application of the improvement standards

The Final Regulations supersede the 2011 Temporary Regulations. Treasury and the IRS have requested comments on the 2013 Proposed Regulations by November 18, 2013, in advance of the public hearing on the 2013 Proposed Regulations scheduled for December 19, 2013.

# Materials and supplies

As under pre-January 1, 2014 law, incidental materials and supplies (i.e., materials and supplies for which the taxpayer does not maintain a record of consumption or take physical inventories at year end) are deductible when purchased. Non-incidental materials and supplies are deductible when used or consumed.

The Final Regulations generally retain the 2011 Temporary Regulations definition of a material and supply, but increase the dollar per unit or property amount from $100 to $200. Thus, the Final Regulations define a material and supply as tangible property used or consumed in the taxpayer's operations that is not inventory and is:

- A component acquired to maintain, repair, or improve a unit of tangible property (includes rotable and temporary spare parts);
- Fuel, lubricants, water, or similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in taxpayer's operations (new category);
- A unit of property that has an economic useful life of 12 months or less;
- A unit of property with an acquisition or production cost of $200 or less; or
- Property identified in published guidance.

The Final Regulations provide special rules for the interaction of materials and supplies with the new de minimis safe harbor election (discussed below). In general, if a taxpayer makes a de minimis safe harbor election, materials and supplies that fit within the de minimis safe harbor election are accounted for under the de minimis safe harbor and not as materials and supplies.

Unlike the 2011 Temporary Regulations, the Final Regulations limit the election to capitalize and depreciate materials and supplies to rotable and temporary spare parts. The Final Regulations also retain the special rules for rotable and temporary spare parts ("rotables"). The default treatment is to deduct rotables when used or consumed (i.e., when disposed of); however, a taxpayer may elect to capitalize and depreciate rotables or elect an optional method treatment. Under the optional method, the taxpayer deducts its basis in the rotable in the year it is placed in service; recognizes income when the rotable is removed; capitalizes costs to fix the rotable; and then claims a deduction for such basis when the rotable is once again placed in service.

Additionally, otherwise deductible materials and supplies may be subject to capitalization under IRC § 263A, or as an improvement under Treas. Reg. § 1.263(a)-3.

# Amounts paid to acquire or produce tangible property

Amounts paid to acquire or produce tangible property or to defend or perfect title to such property must be capitalized. In addition, a taxpayer must capitalize amounts paid to facilitate the acquisition or production of tangible property. The determination of whether costs associated with activities are facilitative is based on facts and circumstances. The Final Regulations, like the 2011 Temporary Regulations, provide a list of inherently facilitative activities similar to the list in Treas. Reg. § 1.263(a)-5, and include, among other costs, bidding costs; finders' fees or brokers' commissions; and costs of securing an appraisal.

## Facilitative costs

Under the Final Regulations non-inherently facilitative pre-decisional investigatory costs paid in pursuing the acquisition of real property are not considered facilitative, and therefore are not required to be capitalized, if paid for activities performed in the process of determining whether and which real property to acquire. Because this special rule only applies to the acquisition of real property, an allocation of facilitative costs between real and tangible personal properties may be required if both real and tangible personal properties are acquired in a single transaction. The amount of non-inherently facilitative pre-decisional investigatory costs reasonably allocated to the real property can be deducted, while costs reasonably allocated to the acquisition of personal property must be capitalized.

The Final Regulations also provide that employee compensation and overhead costs related to the acquisition of tangible property are not subject to capitalization under IRC § 263(a); however, such costs may be required to be capitalized under IRC § 263A.

## De Minimis Safe Harbor Election

The de minimis rule provided in the 2011 Temporary Regulations permitted a taxpayer to deduct certain expenditures consistent with the treatment on its applicable financial statement ("AFS") subject to a ceiling. In response to overwhelming comments, the IRS and Treasury in the Final Regulations provide a new elective de minimis safe harbor.

### Taxpayers with an AFS

Under the de minimis safe harbor election, an eligible taxpayer may generally deduct amounts paid for property, where the per item or per invoice amount does not exceed $5,000. An eligible taxpayer is a taxpayer that — (1) has an AFS, (2) has a written capitalization policy as of the first day of the tax year to expense amounts paid for tangible property costing less than a certain dollar amount or having a useful life of 12 months or less, and (3) expenses amounts on its AFS consistent with the written policy. Similar to the 2011 Temporary Regulations, the Final Regulations provide that the determination of whether the taxpayer has an AFS and the appropriate written policy to expense amounts below a certain threshold can be made at the consolidated group level.

For purposes of the de minimis safe harbor election, an AFS is a financial statement provided to the Securities and Exchange Commission ("SEC"), an audited financial statement used for creditors or other non-tax purpose, or a financial statement provided to a U.S. federal or state governmental agency other than the IRS or SEC. The Final Regulations make it clear that if a taxpayer is included in a financial accounting consolidated group's AFS, it is considered to have an AFS. Thus, for example, partnerships and controlled foreign corporations that are included in a consolidated AFS meet the AFS requirement for the de minimis safe harbor election.

In determining the per invoice or per item amount for purposes of applying the $5,000 limit, transaction and other costs that are included on the same invoice as the item are included in determining the cost of the item. The Final Regulations also provide guidance for allocating lump sum invoice amounts among the items on the invoice, where the invoice does not provide a per unit amount.

As noted above, if a taxpayer makes the de minimis safe harbor election, any materials and supplies that fit within the de minimis safe harbor are treated as expensed under the de minimis safe harbor election and not as materials and supplies.

The Final Regulations also clarify that IRC § 263A may apply to amounts expensed under the de minimis safe harbor election. For example, if a taxpayer expenses an amount under the de minimis safe harbor election such as a small tool and that tool is used by the taxpayer to produce inventory, the cost of the tool must be capitalized as an indirect cost of the inventory produced by the taxpayer.

The Final Regulations also include an anti-abuse rule to prevent taxpayers from improperly splitting costs normally included on a single invoice among multiple invoices for purposes of meeting the $5,000 safe harbor limit.

The de minimis safe harbor election is an annual, irrevocable election. The election is made by attaching a statement to the taxpayer's timely filed (including extensions) original tax return for the tax year for which the election is made. The de minimis safe harbor election may be made for a tax year beginning on or after January 1, 2012 and ending before September 19, 2013, on an amended return that is filed within 180 days of the extended due date of the return for such tax year (whether or not the taxpayer extended such return).

## Taxpayers without an AFS

For taxpayers without an AFS, the rules described above will generally apply, however, the dollar threshold is reduced from $5,000 to $500.

### Practice consideration

The preamble to the Final Regulations indicates that the issuance of the regulations is not intended to disturb the treatment of minimum capitalization threshold agreements between examiners and taxpayers, provided such agreements clearly reflect income.

All taxpayers, even those with capitalization policies with thresholds in excess of $5,000 should consider making the annual election, as such election may protect the deduction of $5,000 or less per item from challenge on exam. This limits the potential exposure to those amounts in excess of $5,000 for companies that do not have agreements with their IRS exam teams.

Taxpayers with 'prepaid supplies' or deferred supplies expenses would not treat such supplies under the de minimis safe harbor election because such amounts are not expensed under the taxpayer's capitalization policy.

Taxpayers with an AFS desiring to make the de minimis safe harbor election should confirm they have the requisite written capitalization policy as of the beginning of the tax year for which the election is to be made.

**Example**

At the beginning of Year 1, assume E has an AFS and a written accounting policy that it follows, to expense amounts paid for property costing less than $10,000. In Year 1, E pays $45,000 for the purchase and installation of 10 wireless routers. Assume that each wireless router is a unit of property. E receives an invoice from its supplier indicating the total amount due ($45,000), including the material price per item ($2,500), and total delivery and installation ($20,000). E allocates the additional invoice costs to the materials on a pro rata basis, bringing the cost of each router to $4,500 ($2,500 materials + $2,000 labor and overhead).

The amounts paid for each router, including the allocable additional invoice costs, meet the requirements for the de minimis safe harbor. If E elects to apply the de minimis safe harbor for Year 1, E may not capitalize the amounts paid for the 10 routers (including the additional invoice costs) or any other amounts meeting the criteria for the de minimis safe harbor. Instead, E may deduct these amounts under Treas. Reg. §1.162-1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

# Amounts paid to improve tangible property

For many taxpayers, the most significant aspects of the 2013 Regulations are the provisions addressing the treatment of amounts paid to improve tangible property (i.e., the so-called "repair" regulations). The Final Regulations generally provide that amounts paid to improve a unit of real or personal tangible property must be capitalized. An amount is considered paid to improve a unit of property ("UoP") if it results in: (i) a betterment of the UoP; (ii) a restoration of the UoP; or (iii) an adaptation of the UoP to a new or different use.

If a type of maintenance is a recurring activity that the taxpayer reasonably expects to perform as a result of the taxpayer's use of the UoP to keep the UoP in its ordinarily efficient operating condition, then the amount paid may qualify for the routine maintenance safe harbor (discussed below). Additionally, the Final Regulations provide for a limited capitalization election that permits taxpayers to elect to capitalize for tax amounts that would otherwise be deductible repairs for tax purposes.

## Definition of unit of property

The Final Regulations provide that unless otherwise specified, the UoP is determined using a functional interdependence standard, under which the placing in service of one component by the taxpayer depends on the placing in service of the other component by the taxpayer. Special UoP rules are provided for buildings, leased property, plant property, and network assets.

The Final Regulations also provide that a component of a UoP must be treated as a separate UoP if that component (i) is properly treated as being within a different MACRS class (as determined under IRC § 168(e)) than the class of the larger UoP; or (ii) has been properly depreciated using a different depreciation method. This MACRS consistency rule applies during the placed in service year of the asset and in future years (e.g., if the taxpayer completes a cost segregation study).

### Building and its structural components

The Final Regulations define a building and its structural components as a single UoP, but require that the improvement standards be applied separately to the building structure and the following building systems:

- Heating, ventilation, and air conditioning systems (HVAC);
- Plumbing systems;
- Electrical systems;
- All escalators;
- All elevators;
- Fire protection and alarm systems;
- Security systems;
- Gas distribution systems; and
- Any other structural component identified in published guidance.

**Practice consideration**

Roof replacements are a common example used to illustrate the operation of the building UoP rules. The work performed on the roof must be measured against the building structure (defined as the building and its structural components, other than the building systems above) to determine whether an improvement to the UoP occurs.

The requirement to apply the improvement standards to the building structure and each building system is a significant change that will likely result in additional capitalizable improvements. Taxpayers that previously categorized repair expenditures as deductible or capitalizable by comparing work performed to the entire building should consider changing their method of accounting to comply with the Final Regulations.

## Plant property

Plant property is "functionally interdependent machinery or equipment, other than network assets, used to perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or similar activities."

The UoP for plant property is initially determined based on the functional interdependence standard. However, the Final Regulations provide that functionally interdependent plant property is further divided into smaller UoPs based on a component or a group of components that perform a discrete and major function or operation.

No changes were made to the 2011 Temporary Regulations definition of plant property, indicating that the government continues to believe that, “the discrete and major function rule provides a reasonable and administrable limitation on the functional interdependence standard, which otherwise could be overly broad in its application to industrial equipment.”

**Practice consideration**

The discrete and major function standard often results in a UoP smaller than the taxpayer’s UoP under its present method of accounting. This is particularly relevant for taxpayers whose “industrial process” requires that a product move uninterrupted from one end of the production line to another to produce a salable product. Taxpayers with functionally interdependent production lines (e.g., aluminum milling or certain chemical manufacturers) often defined the entire line as the UoP under prior law. Taxpayers with plant property that previously categorized repair expenditures as deductible or capitalizable by comparing work performed to the entire production line should consider changing their method of accounting to comply with the Final Regulations.

**Examples**

Taxpayer uses many different machines in an assembly-line like process to treat, launder and prepare linens. Because this equipment is plant property used in an industrial process, each sorter, boiler, washer, dryer, etc. must be treated as a separate UoP.

Taxpayer, a restaurant, serves food to customers on its premises. The restaurant employs equipment in an assembly-line like process to prepare and cook tortillas. Contrary to the example above, because this equipment is property that is not used in an industrial process (i.e., it performs a small-scale function in a restaurant), the UoP in this example is the tortilla making equipment apparatus as a whole.

## Network assets

The Final Regulations provide that the UoP for network assets is determined by the taxpayer's particular facts and circumstances or as provided in published guidance (see e.g., Rev. Proc. 2011-27 for wireline network assets, Rev. Proc. 2011-28 for wireless networks assets and Rev. Proc. 2011-43 for electric transmission and distribution property). It is anticipated that the IRS will issue similar guidance for other industries with network assets (e.g., cable and gas transmission and distribution) during 2013.

## Leased property

Like the 2011 Temporary Regulations, under the Final Regulations, a taxpayer that is a lessor of a building or other non-building property applies the general rule for determining the UoP and improvements. For a taxpayer that is a lessee of all or a portion of one or more buildings, the UoP is each building and its structural components associated with the leased portion of the building. Accordingly, a taxpayer-lessee must apply the improvement standards (as discussed below) to the leased building or leased portion of the building and the related building systems. Lessee improvements made to a unit of leased property is a separate UoP. For non-building leased property, the general functional interdependence test applies except that the UoP may not be larger than the unit of leased property.

**Practice Consideration**

The Final Regulations clarify that if a lessee makes an expenditure for work on an improvement to a leased building the lessee previously made, the lessee looks to the entire leased building and not just the improvement to determine whether the expenditure is a capitalizable improvement.

**Example**

Taxpayer leases two office spaces in the same building under separate agreements. Each office space contains a separate HVAC unit. The taxpayer must treat the HVAC unit associated with one leased office space as a building system of that leased space and the HVAC unit associated with the second leased office space as a building system of that second leased space.

## Improvement standards

Once a taxpayer has determined the appropriate UoP, the next step is to analyze whether the expenditure is an improvement to the UoP resulting in capitalization. As discussed above, an amount is considered paid to improve a UoP if it results in: (i) a betterment of the UoP; (ii) a restoration of the UoP; or (iii) an adaptation of the UoP to a new or different use. The Final Regulations retain the conceptual framework from the 2011 Temporary Regulations; however, despite requests from commenters for bright-line safe harbors, the Final Regulations generally require a facts and circumstances analysis to determine whether an expenditure is an improvement.

Taxpayers must capitalize all direct costs of an improvement. Additionally, all indirect costs that directly benefit or are incurred by reason of the improvement must be capitalized. This rule replaces the judicially created "plan of rehabilitation" doctrine that was the subject of considerable litigation. In applying the standards, the Final Regulations provide that an amount is not necessarily deductible solely because the repair is required to comply with regulatory requirements.

The Final Regulations also specifically address the treatment of removal costs providing that such costs are not capitalized if the taxpayer has taken into account the adjusted basis of the removed asset or component of the asset in computing gain or loss. If the taxpayer has not taken into account the adjusted basis of the removed asset, the taxpayer must evaluate whether the removal costs are deductible repairs or capitalized improvements under the general rules.

## Small taxpayer safe harbor election

In response to comments, the Final Regulations include a small taxpayer safe harbor election under which a taxpayer with average annual gross receipts of $10 million or less can expense repairs, maintenance, and improvements that are made with respect to an owned or leased eligible building property, and the total cost of which for the tax year is $10,000 or less. For purposes of the election, an eligible building property is a building with an adjusted basis of $1 million or less. The unadjusted basis of a leased building is determined based on the total rents to be paid over the lease term (taking into account reasonably expected renewals).

If the total repair, maintenance and improvement costs for the tax year exceed $10,000 for an eligible building property, the election is not available for that property for that tax year.

The small taxpayer safe harbor election is made annually by attaching the requisite statement to a timely-filed (including extensions) original federal tax return. The small taxpayer safe harbor election may be made for a tax year beginning on or after January 1, 2012 and ending before September 19, 2013, on an amended return that is filed within 180 days of the extended due date of the return for such tax year (whether or not the taxpayer extended such return).

## Betterment

The Final Regulations provide that, in general, an amount paid results in a betterment of a UoP if it:

- Corrects a material condition or defect existing prior to the taxpayer's acquisition of the UoP or one that arose during the production of the UoP, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;
- Is for a material addition (e.g., physical enlargement, expansion, extension, or addition of a major component) to the UoP; or
- Is reasonably expected to materially increase the productivity, efficiency, strength, quality or output of the UoP.

The Final Regulations provide an appropriate comparison rule instructing taxpayers how to apply the betterment analysis. When a particular event necessitates the expenditure, the analysis is performed by comparing the condition of the property after the expenditure with the condition of the property immediately before the event. If an expenditure is necessitated by normal wear and tear, the condition of the property after the expenditure is compared with the condition of the property immediately after the last time the taxpayer corrected the effects of wear and tear. If an expenditure is to correct damage to a UoP, the appropriate comparison is to the condition of the property immediately prior to the damage.

In determining whether an expenditure results in a betterment, a taxpayer must consider all facts and circumstances. If an addition or increase in a particular factor cannot be measured (e.g., increase in productivity of a building), then that factor is not relevant in determining whether there has been a betterment to the UoP.

The replacement of a part with an improved, but comparable part where the same type of part is not practicably available, is not, in and of itself, a betterment. Additionally, the Final Regulations remove the taxpayer's treatment of an expenditure on its financial statement as a factor in determining whether an expenditure is a betterment.

**Practice consideration**

The betterment standard is highly factual, and combined with the revisions to certain UoP definitions (discussed above), requires taxpayers to compare the repair cost against the UoP to determine whether an amount paid results in a betterment to that UoP.

Three sequential examples in the Final Regulations (as summarized below) illustrate the betterment standard, including the interplay of IRC § 263A (otherwise deductible amounts must be capitalized if they directly benefit or are incurred by reason of an improvement to a UoP) by analyzing the refresh and remodel of a chain of retail stores.

**Examples**

Taxpayer periodically refreshes the look and layout of its stores, including replacing and reconfiguring display tables and racks, relocating lighting, repairing floors, repainting, replacing damaged ceiling tiles, and patching holes in the walls. The refresh does not result in any material additions to, or material increases in the capacity of the buildings' structure or systems compared to the condition of the structure or systems after the previous refresh. The refresh is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of any building structure or system compared to the condition of the structures or systems after the previous refresh, accordingly, the only capitalized amounts are those paid to acquire and install the tangible personal property.

Assume the same facts as above, except the taxpayer also adds storage space, loading dock, overhead door, and expands the electrical system. The costs for these items are capitalizable betterments to the building structure and electrical system because they result in material additions to and material increases in the capacity of the structure and the electrical system of the building. For the same reasons discussed above, the taxpayer is not required to treat the amounts paid for the refresh of its store building structure and systems as capitalizable betterments.

Assume taxpayer decides to change to focus on upscale retail market. To that end, the taxpayer substantially remodels its store by rebuilding the interior and exterior facades, replacing walls with windows, replacing escalators with a monumental stair case, removing and rebuilding walls, replacing lighting and plumbing upgrade fixtures, replacing vinyl flooring with ceramic flooring, and painting existing walls. All amounts other than the painting are for material additions to the building structure, material increases in the capacity of the electrical system, or are reasonably expected to increase the efficiency and quality of the plumbing system. The amount paid to repaint existing walls, while not a betterment by itself, directly benefitted and was incurred by reason of the improvements to taxpayer's store buildings structure and electrical systems, and must be capitalized.

## Restoration of property

In general, the Final Regulations require the capitalization of amounts paid to restore a UoP. For these purposes, restoration includes:

- Replacing a component of a UoP if the taxpayer has properly deducted a loss for that component (other than a casualty loss under Treas. Reg. § 1.165-7);
- Replacing a component of a UoP if the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss from the sale or exchange of the component;
- Repairing damage to a UoP for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under IRC § 165, or relating to a casualty event described in IRC § 165;
- Returning a property to its ordinarily efficient operating condition from a state of nonfunctional disrepair;
- Rebuilding the property to a like-new condition after the end of its class life; or
- Replacing a part or a combination of parts that comprise a major component or substantial structural part of a UoP.

The Final Regulations clarify that comprehensive maintenance program, even if substantial, does not rebuild property to a like-new condition. Additionally, the Final Regulations provide that with respect to property that is depreciated to salvage value (e.g., property not depreciated using ACRS or MACRS), a taxpayer is not required to treat amounts paid for the replacement of a component as a capitalizable restoration if the loss is property deducted or the adjusted basis of the component is realized from a sale or exchange, and the amount of the loss or adjusted basis is solely attributable to the remaining salvage value.

The Final Regulations add a new casualty loss rule, which provides that the amount required to be capitalized as a restoration of damage to a UoP is limited to the excess of — (1) the adjusted basis of the single identifiable property for determining the loss on the casualty, over (2) the amount paid to restore the damage to the UoP from the casualty that would otherwise be a capitalized improvement. Taxpayers must determine whether amounts in excess of this limitation are deductible repairs or must be capitalized under the improvement standards.

The Final Regulations also provide additional clarification for determining whether an expenditure is for the replacement of a major component or substantial structural part. In particular, the Final Regulations provide additional guidance for buildings (and structural components thereof) and building systems.

**Practice consideration**

Basis recovery on the disposition of property is a critical component of the restoration improvement standard. As a result, understanding the disposition rules (discussed below) is important to maintaining flexibility in claiming a loss deduction upon a disposition or a deduction to repair the UoP.

The new casualty loss rule addresses only the most sympathetic case — a taxpayer that suffers a casualty loss to low basis, high value property. Taxpayers hoping for a rule that would permit both a casualty loss under IRC § 165 and a repair deduction will be disappointed with the new casualty loss rule.

**Examples**

Assume a taxpayer decides to replace several non-functional components of its walk-in freezer. The taxpayer abandons the old freezer components and properly recognizes a loss from the abandonment of the components. The taxpayer replaces the abandoned freezer components with new components and incurs costs to acquire and install the new components. The costs to acquire and install the replacement components are capitalized as a restoration because the taxpayer replaced components for which it had properly deducted a loss.

Taxpayer owns an office building which has a HVAC system containing ten roof-mounted units, controls and air ducts. Due to climate control problems, the taxpayer replaces three of the roof-mounted units. The ten units perform a discrete and critical function within the HVAC system and therefore are a major component of the HVAC system. However, three units are not a significant portion of a major component of the HVAC system. Provided the taxpayer does not recover basis on the retirement of the two roof-mounted units, the taxpayer is not required to treat the amount paid to replace the two units as a restoration of a building.

## Adaptation to new or different use

In general, a taxpayer must capitalize amounts paid to adapt a UoP to a new or different use. An amount paid is considered for a new or different use if the adaptation is not consistent with the taxpayer’s intended ordinary use of the UoP at the time originally placed in service by the taxpayer.

For example, the Final Regulations provide that in the case of a building, an amount is paid to adapt the UoP to a new or different use if it adapts to a new or different use any of the properties specifically designated in the Final Regulations (i.e., buildings, condominiums, cooperatives and leased buildings).

## Routine maintenance safe harbor

The Final regulations retain and expand upon the routine maintenance safe harbor included in the 2011 Temporary Regulations. The routine maintenance safe harbor applies to routine and recurring activities that, as of the date the UoP is placed in service, a taxpayer reasonably expects to perform more than once during the UoP's alternative depreciation system ("ADS") class life as a result of a taxpayer's use of the property. The safe harbor is applicable to a building, structural components of buildings, and building systems, but the taxpayer must reasonably expect to perform the activities more than once during the 10-year period beginning with the placed in service date of the building, structural component, or building system.

A taxpayer must take into consideration the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience when determining whether activities are considered routine maintenance. A taxpayer's expectation is not considered unreasonable simply because the taxpayer does not actually perform the maintenance a second time during the property's ADS class life (10-year period for buildings), provided the taxpayer can otherwise substantiate the reasonableness of its expectation.

An activity is not considered routine and recurring if it results in a betterment or adaptation; is performed on property where a taxpayer has taken into account the adjusted basis of the property (e.g. by claiming a loss); or if the property is in a state of nonfunctional disrepair prior to the expenditure. Additionally, the Final Regulations provide that the routine maintenance safe harbor is not available for network assets.

**Practice consideration**

The routine maintenance safe harbor effectively offers relief for certain expenditures that are otherwise capitalizable as restorations. Thus, for example, the routine maintenance safe harbor may allow a deductible repair for what was otherwise a capitalizable restoration because it is a replacement of a major component or substantial structural part of a UoP.

Taxpayers should confirm they have sufficient substantiation to support their reasonable expectations with respect to amounts for which they claim a deduction under the routine maintenance safe harbor.

The routine maintenance safe harbor is not an elective provision. Accordingly, to the extent an expenditure fits within the safe harbor, a taxpayer must account for the expenditure under the routine maintenance safe harbor.

**Examples**

Aircraft engines undergo engine shop visits ("ESV") on a regular basis. Taxpayer performs ESV during and after the class life of the aircraft. The costs associated with the ESV are deemed not to improve the aircraft under the safe-harbor for routine maintenance because the ESV involved the same routine maintenance activities (that also qualified under the safe harbor) that were performed on the same aircraft engines during their class life.

Taxpayer replaced the lining of a container that constitutes 60% of the physical structure of the container. These replacements occur on a regular basis throughout the life of the container. Notwithstanding the substantial nature of the replacement, the costs qualify as repairs activities under the routine maintenance safe harbor.

In Year 1, taxpayer acquired and placed in service a building. At that time, based on manufacture suggestions and industry practice, the taxpayer reasonably expected to perform preventative maintenance on the HVAC system every four years. In Year 4, the taxpayer pays a contractor to perform the maintenance on the HVAC system. However, the taxpayer does not perform the maintenance again until Year 12. The taxpayer's reasonable expectation that it would perform the HVAC maintenance every four years will not be considered unreasonable solely because it did not perform such maintenance every four years, provided the taxpayer can substantiate that its expectation was reasonable when the HVAC system was placed in service.

## Capitalization election

The Final Regulations provide taxpayers with an annual, irrevocable election to capitalize amounts paid during the taxable year for repair and maintenance of tangible property that are capitalized on its books and records. The election applies to all amounts paid for repairs and maintenance that are capitalized on the taxpayer's books and records. The amounts capitalized under the election are depreciated beginning when the asset is placed in service.

The annual election is made by attaching a statement to the taxpayer's timely filed (including extensions) original tax return for the tax year for which the election is made. The capitalization election may be made for a tax year beginning on or after January 1, 2012 and ending before September 19, 2013, on an amended return that is filed within 180 days of the extended due date of the return for such tax year (whether or not the taxpayer extended such return).

**Practice consideration**

This capitalization election is not a strict book conformity election. Amounts expensed on a taxpayer's books and records are subject to otherwise applicable Code and regulation provisions, and must be analyzed accordingly.

# Dispositions of MACRS property

Under the 2013 Proposed Regulations, a disposition occurs when ownership of the asset is transferred or when the asset is permanently withdrawn from use. A disposition includes the sale, exchange, retirement, physical abandonment, destruction of an asset or transfers of an asset to a supplies, scrap, or similar account. In a significant departure from the 2011 Temporary Regulations, the 2013 Proposed Regulations have removed the retirement of a structural component of a building from the definition of a disposition of MACRS property. Instead, the 2013 Proposed Regulations include a partial disposition as a disposition of MACRS property. This provision, along with others discussed below, provide flexibility for a taxpayer to determine at the disposition date, whether to claim a loss on a partial disposition of an asset or claim a repair deduction, if available.

## Disposition of an Asset

The 2013 Proposed Regulations provide that a building, including its structural components, is the asset for disposition purposes. The Proposed Regulations also provide that the disposition rules apply to a partial disposition. This allows a taxpayer to claim a loss upon the structural component of building or a component of any other asset without having to identify the component as an asset prior to disposition.

A taxpayer may elect to apply treat a partial disposition of an asset as a disposition. As a result of the election, the taxpayer recognizes gain or loss on the disposition. The election is made in the taxable year in which the disposition occurs and is made by recognizing the gain or loss on the return for such year. Additionally, a late election may be made if, on exam, the taxpayer's repair deduction with respect to the asset for which the election was made is recharacterized as a capitalizable improvement.

The partial disposition rule is mandatory for partial dispositions resulting from a casualty event, a disposition for which gain is not recognized under IRC §§ 1031 or 1033, a transfer of an asset (or portion of an asset) in a transaction described in IRC § 168(i)(7), or the sale of a portion of an asset (even if no partial disposition election is made).

A taxpayer that applies the partial disposition rules to assets classified in assets classes 00.11 through 00.4 of Rev. Proc. 87-56, must meet the additional requirement of depreciating the capitalized improvement costs under the same asset class as the disposed of property.

**Practice consideration**

The partial disposition election effectively provides a taxpayer the flexibility of claiming a loss on the disposition of a structural component of a building or a repair deduction for the cost of the new/repaired structural component. The new partial disposition election replaces the complicated general asset account election and qualifying disposition election regime under the 2011 Temporary Regulations under which taxpayers could achieve a similar flexibility.

Taxpayers that previously made accounting method changes based on the 2011 Temporary Regulation definition of a disposition that included a retirement of a structural component of a building likely will need to change their method to comply with the new disposition definitions.

**Example**

A taxpayer replaces one of four elevators (a structural component) in its office building. The office building (including its structural components) is the asset for disposition purposes. The taxpayer does not make the partial disposition election for the elevator.

The retirement of the replaced elevator is not a disposition. The taxpayer continues to depreciate the cost of the building (including the cost of the retired elevator and the building's other structural components), and the taxpayer does not recognize a loss for the retired elevator. If the taxpayer must capitalize the amount paid for the replacement elevator as an improvement, the replacement elevator is a separate asset for disposition and depreciation purposes.

If the taxpayer makes a partial disposition election for the elevator, the retirement of the elevator is a disposition. Depreciation for the retired elevator ceases at the time of its retirement (taking into account the applicable convention), and the taxpayer recognizes a loss upon retirement of the elevator. The taxpayer must capitalize the amount paid for the replacement elevator as a restoration, and the replacement elevator is a separate asset for disposition and depreciation purposes.

## General asset accounts

An alternative to the general rule of depreciation is the election to use the general asset accounts ("GAA"). Under the 2013 Proposed Regulations, each GAA is effectively treated as the asset. However, each GAA must include only assets that have the same depreciation method, recovery period, and convention and are placed-in-service in the same taxable year. The 2013 Proposed Regulations also provide special rules for assets for which bonus depreciation is claimed, and for assets for which the mid-month convention applies.

No loss is realized upon the disposition of an asset in a GAA. The disposed asset is treated as having an adjusted depreciable basis of zero immediately before the disposition. Therefore, the unadjusted depreciable basis and depreciation reserve of the GAA is unaffected by the disposition. A taxpayer can elect to terminate a GAA upon the disposition of all assets in the GAA or the last asset in the GAA. The 2013 Proposed Regulations eliminate the expansive qualifying disposition election that was in the 2011 Temporary Regulations. Thus, under the 2013 Proposed Regulations, a qualifying disposition is limited to certain extraordinary events (e.g., casualties, charitable contributions, cessation of the business, plant, facility, or for nonrecognition transactions).

**Practice consideration**

Taxpayers no longer need to make a GAA to have flexibility in claiming a loss on a partial disposition or a repair deduction. Taxpayers that previously made GAA elections under the 2011 Temporary Regulations may want to reconsider those elections given the changes to the disposition rules and the inability of a taxpayer to claim a partial disposition loss for assets in a GAA.

A taxpayer should also consider whether a GAA election is appropriate to reduce administrative burden.

# Large business and international division directive

## General

On March 22, 2013, the IRS Large Business and International Division ("LB&I") issued an updated directive to discontinue any exam activity relating to positions taken on original returns for tax years beginning before January 1, 2012, relating to (1) whether costs incurred to maintain, replace, or improve tangible property must be capitalized under IRC § 263(a); and (2) any correlative issues involving the disposition of structural components of a building or tangible depreciable assets (other than a building or its structural components).

The directive does not apply to current examination activity relating to costs for which the IRS provided specific guidance separate from the 2011 Temporary Regulations (e.g., Rev. Procs. 2011-27, 2011-28, or 2011-43), or issues that do not address capitalization of costs under IRC § 263(a).

In addition to directing examiners to cease current exam activity, the directive instructs examiners:

- Not to begin new exam activity with respect to the issues;
- If the taxpayer has filed a method change on or after December 27, 2011, for a tax year beginning on or after January 1, 2012 and before January 1, 2014, to assess and determine, in consultation with the appropriate issue practice groups, whether to examine the Form 3115;
- For examination of tax years beginning on or after January 1, 2012 and before January 1, 2014, to determine if Form 3115 is filed in accordance with the applicable guidance, and if so, to perform the appropriate risk assessment; if no, and the scope limitation period has passed, perform a risk assessment on the issue; and
- For examination of tax years beginning on or after January 1, 2012, but before January 1, 2014, determine if the taxpayer has changed its method of accounting with respect to (1) whether costs incurred to maintain, replace, or improve tangible property must be capitalized under IRC § 263(a); and (2) any correlative issues involving the disposition of structural components of a building or tangible depreciable assets (other than a building or its structural components), and if so, perform a risk assessment regarding the method change. If the taxpayer has not changed its method of accounting, examiners are advised not to examine the issue.
- For tax years beginning after January 1, 2014, perform a risk assessment taking into consideration whether the IRC § 481(a) adjustment is properly computed.

# Summary of method changes/ elections under the final and re-proposed regulations

| Method changes | Elections |
|---|---|
| Deduct incidental M&S when purchased | Elect to capitalize rotable or temporary spare parts (Treas. Reg. § 1.162-3(d)) |
| Deduct non-incidental M&S when used or consumed | *De minimis safe harbor election (Treas. Reg. § 1.263(a)-1(f)) |
| Deduct non-incidental rotable, temporary and emergency spare parts when disposed | Election to capitalize employee compensation and overhead associated with the acquisition of tangible property (Treas. Reg. § 1.263(a)-2(e)(2)(iv)(B)) |
| Capitalize and depreciate rotable and temporary spare parts | *Small taxpayer safe harbor election (Treas. Reg. § 1.263(a)-3(h)) |
| Optional method of accounting for rotable and temporary spare parts | *Capitalization election (Treas. Reg. § 1.263(a)-3(n)) |
| Deduct certain costs for investigating or pursuing the acquisition of real | General asset account election (Prop. Treas. Reg. § 1.168(i)-1) |
| Deduct dealer expenses that facilitate the sale of property | Optional termination of general asset account upon the disposition of last or all of the assets in a general asset account (Prop. Treas. Reg. § 1.168(i)-1(e)(3)(ii)(A)) |
| Capitalize non-dealer expenses that facilitate the sale of property | Optional recognition upon qualifying disposition (Prop. Treas. Reg. § 1.168(i)-1(e)(3)(iii)(A)) |
| Capitalize acquisition or production costs | *Partial disposition election (Prop. Treas. Reg. § 1.168(i)-8(d)(2)) |
| Change units of property | |
| Capitalize improvements to tangible property | |
| Deduct repair and maintenance costs | |
| Deduct eligible amounts under the routine maintenance safe harbor | |
| Regulatory method of accounting | |
| Changes for assets within a general asset account to comply with Prop. Treas. Reg. § 1.168(i)-1 | |
| Changes to comply with the disposition rules except the partial disposition election (Prop. Treas. Reg. § 1.168(i)-8) | |

* Election can be made on an amended return for a taxpayer's year beginning on or after January 1, 2012, and ending on or before September 19, 2013. The amended return is due within 180 days of the extended due date of the return for such year

# Summary of significant changes in final and re-proposed regulations

| Issue | Cite** | Temporary regulations | Final regulations |
|---|---|---|---|
| **Definition of Materials & Supplies (M&S)** | § 1.162-3(d) | M&S includes amount paid for a unit of property costing $100 or less | M&S includes amounts paid for a unit of property costing $200 or less |
| **M&S interaction with De Minimis Rule** | § 1.162-3 | Taxpayer can elect to include M&S under the de minimis rule | If taxpayer elects de minimis safe harbor, supplies that fit under the de minimis rule must be accounted for under that rule |
| **De Minimis Rule** | § 1.263(a)-1(f) | • Only available for taxpayers with an AFS<br>• Limit on amounts expensed under a minimum capitalization threshold to the lesser of — (1) .1% of tax gross receipts, or (2) 2% of book depreciation<br>• Excluded amounts for labor and overhead costs<br>• Interaction with section 263A unclear | • Elective safe harbor for taxpayers with (1) an AFS, (2) written accounting procedures that treat as an expense — (a) amounts paid for property costing less than a specified dollar amount, or (b) amounts paid for property with an economic useful life of 12 months or less, (3) the taxpayer treats the amount paid for property as an expense on its AFS in accordance with its written procedures, and (4) the amount paid for the property does not exceed $5,000<br>• Taxpayers without an AFS eligible, but amount paid for property is limited to $500<br>• Transaction and additional costs included on invoice treated as cost of property<br>• Clarifies that section 263A may still apply<br>• Includes anti-abuse rule |
| **Small Taxpayer Safe Harbor Election** | § 1.263(a)-3(h) | • None | • Taxpayers with average annual gross receipts of $10 million or less may elect to not apply the capitalization provisions with respect to repairs, maintenance, or improvement costs paid with respect to an eligible building property<br>• An eligible building property is a building that is owned or leased and that has an unadjusted basis of $1M or less<br>• Total amount paid during taxable year for repairs, maintenance, improvements to an eligible building cannot exceed the lesser of — (a) 2% of the unadjusted basis of the building, or (b) $10,000<br>• Once made the election is irrevocable |

**All cites are to the final and new proposed regulations issued September 13, 2013.

| Issue | Cite** | Temporary regulations | Final regulations |
|---|---|---|---|
| **Routine Maintenance Safe Harbor (RMSH)** | § 1.263(a)-3(i) | • Specifically excluded buildings (and building systems) | • Extends the RMSH to buildings (and building systems), if taxpayer reasonably expects to perform more than once during the 10 year period, beginning with the date the building (or building system) is placed in service. |
| **Casualty Loss Rule** | § 1.162-3 | • Restoration standard generally required capitalization of amounts paid to restore a unit of property after a casualty event if taxpayer is required to take a basis adjustment.<br>• Flexibility to deduct repairs expenditures versus casualty loss required general asset account election | • Casualty loss rule limits the amount required to be capitalized after a casualty event to the excess, if any, of — (1) the taxpayer's basis adjustments resulting from the casualty, over (2) the amount paid to restore the unit of property that constitutes a restoration. |
| **Capitalization Election** | § 1.263(a)-3(n) | • None | • Annual election to capitalize otherwise deductible repairs that are capitalized on taxpayers books and records<br>• Does not eliminate need to analyze book repair deductions for tax purposes |
| **Partial Disposition Election** | Prop. Reg. § 1.168(i)-8(d)(2) | • Mandatory disposition of structural components (or portion thereof) of buildings<br>• Taxpayers could elect GAA (and elect a qualifying disposition) to have flexibility to choose to deduct loss on disposition or the costs of deductible repairs | • Treat building (not structural component) as asset for disposition purposes<br>• Taxpayers may elect to apply the partial disposition rule to achieve flexibility in claiming a loss on a partial disposition or claim a repair deduction<br>• Partial disposition election does not apply to dispositions of entire assets |
| **Effective dates** | | • Generally effective for taxable years beginning on or after January 1, 2014, but taxpayers may adopt for taxable years beginning on or after January 1, 2014 | • Generally effective for taxable years beginning on or after January 1, 2014, but taxpayers can early adopt for taxable years beginning on or after January 1, 2012<br>• Taxpayers permitted to make late elections on amended returns for taxable years beginning on or after January 1, 2012, and ending before September 19, 2013, if amended return is filed within 180 days of extended due of such return |

**All cites are to the final and new proposed regulations issued September 13, 2013.

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