January 1:
New resolutions and new repair regulations

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We all know that New Year's resolutions generally go into effect on January first, but this year we should have more on our minds on the first day of 2014: new IRS regulations that will change the way we account for repairs and other expenses related to tangible property.

In September 2013, the IRS issued its final regulations governing expenditures made on tangible property. The principal expenses covered by these regulations are for costs to acquire, produce, and improve tangible property. The question of whether such expenses should be capitalized (and possibly depreciated) or expensed has long been an issue of contention between the IRS and taxpayers.

In September 2013, the IRS issued its final regulations governing expenditures made on tangible property.

Because the earlier temporary regulations for tangible property were issued back in 2011, there has been a lot of time for the IRS to consider if and how they should be revised. You will find these final regulations contain an easing of some of those initial rules, adopt others, and add some new ones. Given an effective date of January 1, 2014, businesses are scrambling to understand them and to ensure compliance. After all, these latest regulations will affect nearly every business that owns fixed assets.

While the effective date for these final regulations is for tax years beginning on or after January 1, taxpayers may, if they choose, apply most of them retroactively to 2012. With careful tax planning, certain taxpayers may find it beneficial to do so.

Background

The final regulations affect how businesses will apply both IRS Code Sections 263(a) and 162. IRS Code Section 263(a) requires businesses to capitalize costs to acquire, produce, and improve tangible property. IRS Code Section 162 allows deductions of all ordinary and necessary business expenses. Section 162 expenses, in the past, have included certain costs of maintenance, repairs, and materials and supplies. In addition, the IRS has issued new proposed regulations affecting disposals of MACRS property.

The earlier 2011 proposed and temporary regulations covered a wide range of expenditures relating to tangible property, including the treatment of:

- Materials and supplies.
- A de minimis rule for expensing qualifying property.
- A "unit of property" and its definition.
- Structural components of buildings (there are nine).
- Improvements made to leased property.
- Disposals.
- General asset accounts.

Principal changes

The principle changes from the earlier regulations include:

- More liberal rules for expensing materials and supplies by doubling the initial threshold from $100 to $200 (although an election to capitalize and depreciate spare parts is allowed).
- Extending the safe harbor for expensing routine maintenance to buildings.
- A new annual election to capitalize maintenance and repair costs that are capitalized on a taxpayer's books and records.
- A de minimis exception for the costs to acquire or produce tangible property that allows the expensing of qualifying property (including materials and supplies) up to $5,000, using a simpler, per item approach.
- Modification of the definitions of betterments and restorations.
- A special safe harbor rule for small businesses that own or lease buildings valued at $1 million or less, allowing up to $10,000 of expensing for improvements.

We will discuss all of these in more depth, as well as review some of the provisions in the earlier 2011 regulations that have now been finalized.

Materials and supplies are tangible property that is used or consumed in the taxpayer's operations and that is not inventory.

Materials and supplies

Except for increasing the threshold from $100 to $200 for the expensing of materials and supplies, the final regulations keep the definition as stated in the earlier proposed regulations. Materials and supplies are tangible property that is used or consumed in the taxpayer's operations and that is not inventory. In addition, materials and supplies are included in one of the following categories:

- Components for the maintenance, repair, or improvement of a unit of tangible property and that are not acquired as part of any single unit of tangible property
- Fuel, lubricants, and similar items not expected to last more than one year
- Units of property with an economic useful life of 12 months or less
- Units of property costing $200 or less to acquire or produce
- Identified in published IRS guidance as constituting materials and supplies

The latest regulations agree with the earlier rules that rotable and temporary spare parts should be treated as materials and supplies. However, standby emergency spare parts will now be included with rotable and temporary spare parts. ("Standby emergency spare parts" are parts acquired for a specific machine but set aside to be used if needed to avoid down time.)

By being included as materials and supplies, rotable, temporary, and standby emergency spare parts may be expensed as they are used or consumed or the taxpayer may elect to capitalize (and depreciate) them. There is also an optional method that may be elected for either rotary or temporary spare parts (standby emergency spare parts do not qualify) whereby:

- The cost of the part is expensed when initially installed.
- The part's fair market value is recognized as income when removed from the property.
- The cost of any repairs, maintenance, or improvements is added to the part's basis.
- The cost of reinstalling the part is deducted.
- Any remaining basis of the part in the year in which it is disposed is also deducted.

The final regulations state that if a business uses the optional method, it must do so for all pools of rotable and temporary spare parts used in the same trade or business. Furthermore, if the optional method is being used for a pool of assets for financial statement purposes, the taxpayer must also use it for those assets for federal tax purposes.

The cost of routine maintenance may be expensed.

Costs of repairs and maintenance

The cost of routine maintenance may be expensed. This guidance is in both the earlier and the final regulations. To qualify as "routine," the expenditures must be made to keep the asset in its efficient operating condition and must be expected to be performed more than once during the asset's class life. Whether or not the expenditures are either expensed or capitalized on the business's financial statements will not affect their tax treatment. Routine maintenance does not include any expenditures for improvements (see the later section Improvements to tangible property), repairs, or maintenance on network assets such as pipelines, railroad track, and telephone lines. However, routine maintenance costs do include expenditures on rotable and temporary spare parts.

One change in the final regulations allows for the expensing of routine maintenance on a building and its structural components but with one caveat: This will apply only if the business reasonably anticipates performing the maintenance more than once in a ten-year period. Since buildings were not included in the earlier 2011 regulations, the extension of the safe harbor for routine maintenance to buildings is definitely a positive improvement to the guidance.

The final regulations also contain a new annual election to capitalize maintenance and repair costs that are capitalized on a taxpayer's books and records. This irrevocable election to opt out of expensing in order to capitalize (and depreciate) them is made by attaching a statement to the taxpayer's timely filed tax return (including any extensions) in the year in which they are paid. Capitalization is often a desirable approach since delaying the recognition of expenditures allows businesses to spread out the deduction and reduce income over a longer period of time.

When the optional method for the treatment of rotary or temporary spare parts, as described above, is made, the election for capitalizing maintenance and repair costs will not apply to such property.

Furthermore, unlike other elections in the final regulations, there is no provision allowing the taxpayer to amend an earlier tax return in order to make this election to capitalize maintenance and repair expenses.

Note that the final regulations require that any repairs made to an asset before it is placed in service must be capitalized. Therefore, if you wish to capitalize repair expenditures, be sure that the work is done after the asset is placed in service.

Under the new guidance, the taxpayer may deduct up to $5,000 of the cost of any item of property.

Costs to acquire or produce tangible property

Generally, both the temporary and final regulations require taxpayers to capitalize the costs of acquiring tangible property (such as transportation and shipping costs), including the costs of investigating and facilitating the acquisition. Some examples of expenditures that facilitate an acquisition are the costs of an engineering study, appraisal fees, and brokers' fees.

The new rules also retain the provision that the costs of employee wages and overhead expenses paid to facilitate the acquisition or production of property are not to be capitalized unless the taxpayer elects to do so. Such election is made on a transaction-by-transaction basis.

Although the costs to acquire or produce tangible property have long been required to be capitalized, the earlier temporary regulations allowed for a de minimis exception to this rule. The de minimis exception, which allowed the expensing of qualifying property and materials and supplies, has now been improved upon by the final regulations.

In the earlier regulations, there was an aggregate ceiling in place to limit the amount that could be expensed each year. That has now been replaced by a simpler, per item approach. Under the new guidance, the taxpayer may deduct up to $5,000 of the cost of any item of property. The $5,000 amount is per item or per invoice, as long as the business has the following:

- An applicable financial statement
- Written accounting procedures for expensing amounts paid for such property under a specified dollar amount (less than the ceiling amount) or for property with an economic useful life of 12 months or less
- The taxpayer must expense such amounts on their financial statements in accordance with these procedures

The final regulations have added a provision that even if the taxpayer does not have an applicable financial statement, there will still be expensing allowed up to $500 per item or invoice.

Note that the $5,000 amount is a safe harbor only. It is possible that a larger amount may be allowed depending on the particular set of facts and circumstances. However, what this does is to provide certainty that amounts under $5,000 will be allowed and will not be subject to challenge on exam. This is also the case for the safe harbor of $500 for businesses without an applicable financial statement.

If the cost of an item exceeds the applicable limit (either the $5,000 or $500, depending on the circumstances), then no portion of the item's cost is allowed to be expensed under the safe harbor rule.

The de minimis rule is a safe harbor that is elected annually by attaching a statement to the taxpayer's tax return for the year of the election. When the election is made, it applies to all qualifying property (and materials and supplies) and it is irrevocable. This latter provision is a change from the earlier regulations. Furthermore, the de minimis rule may be applied to tax years beginning in 2012 or 2013 by amending the affected tax returns.

The final regulations address the issue of removal costs that may occur when an asset must be disposed of as part of an improvement.

Improvements to tangible property

The final regulations are consistent with the earlier proposed regulations requiring the capitalization of amounts paid to improve tangible property. There are three types of expenditures for improvements:

- Those resulting in a betterment to a unit of property
- Those restoring a unit of property
- Those adapting a unit of property to a new or different use

The final regulations address the issue of removal costs that may occur when an asset must be disposed of as part of an improvement. The regulations state that removal costs should be capitalized as part of the improvement provided they either directly benefit or are incurred because of the improvement made to the property.

Under the final regulations, the betterment rules have been modified. A betterment:

- Improves a material condition or defect that existed prior to the property's acquisition or occurred during the property's production (this is unchanged from the earlier regulations).
- Is for a material addition to the unit of property (including a physical enlargement, expansion, extension, or increase in capacity).
- Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the property.

The final regulations also discuss restoration costs. A restoration cost is for one of the following:

- Replacing a component of an asset if the taxpayer has either claimed a loss for the component (other than a casualty loss) or if the taxpayer has taken into account the adjusted basis of the component when calculating the gain (or loss) on the component's sale or exchange
- Repairing damage on an asset for which the taxpayer has taken a basis adjustment due to a casualty
- Returning the property to its regular efficient operating condition if the property has deteriorated so that it could not be used for its intended use
- Rebuilding the property to a like-new condition after the end of its class life
- Replacing a major component or a substantial structural part of the property

The earlier rules for restorations required taxpayers who claimed a casualty loss on property under Section 165 to capitalize any repair costs (as long as the taxpayer adjusted the property's basis due to the casualty loss) rather than being allowed to expense them. This was the case even when the building's adjusted basis was less than the amounts that could otherwise have been considered a repair expense. The final regulations have eased this requirement and now allow the taxpayer to deduct amounts spent for repairs in excess of the damaged property's adjusted basis. However, the taxpayer must still capitalize the costs of restoring the property that are in excess of the amount of adjustments (due to the casualty) to the damaged property's basis over the amount paid for restoring the property that otherwise would be subject to capitalization under the restoration rules. Once this limitation is applied, the remaining casualty expenditures may be deducted as repair expenses as long as they are considered to be ordinary and necessary business expenses.

Here's an example: A building with an adjusted basis of $500,000 is damaged by a weather-related event so seriously that a $500,000 casualty loss is claimed. The taxpayer spends $650,000 to restore the building. He replaces the roof for $300,000 and incurs an additional $350,000 of repair expenditures. The $300,000 roof should be capitalized as it is a major structural component. Next, capitalize $200,000, which is the excess of the adjustments to the damaged property ($500,000) over the amount of the restoration capitalized ($300,000). The remaining casualty expenditures of $150,000 ($350,000 less $200,000) may be deducted as repair expenses.

The final regulations retain the rule for restoration costs that requires capitalizing the costs of rebuilding a property to a like-new condition at the end of its class life. However, these latest regulations clarify that performing a comprehensive maintenance program according to the manufacturer's specifications does not constitute restoring the property to a like-new condition.

The final regulations have eased this requirement and now allow the taxpayer to deduct amounts spent for repairs in excess of the damaged property's adjusted basis.

Unit of property

Most of the language in the final regulations concerns a “unit of property” that is being placed in service, repaired, or improved. The final regulations keep the earlier definition of a “unit of property” as a single unit of property, other than a building, that consists of components that are functionally interdependent. All the components of a unit of property must be of the same class of property and be properly depreciated using the same recovery method for tax reporting.

The rules for what comprises a unit of property for the capitalization rules do not affect how an asset is treated for depreciation. The reverse is not true, however, as how the taxpayer treats an asset for depreciation purposes may affect how it is treated for capitalization purposes.

For real property, a building is considered a unit of property and includes its structural components. However, the major systems of a building are treated as separate units of property.

The nine components of a building (each of which is considered a building system and separate from the building) are:

1. Heating, ventilation and air conditioning systems (HVAC).
2. Plumbing systems.
3. Electrical systems.
4. All escalators.
5. All elevators.
6. Fire protection and alarm systems.
7. Security systems.
8. Gas distribution systems.
9. Any other systems defined in published guidance.

For real property, a building is considered a unit of property and includes its structural components.

Small businesses with buildings

There is a special safe harbor rule in the final regulations for small taxpayers who own or lease buildings valued at $1 million or less. Taxpayers who have average annual gross receipts of $10 million or less during the three preceding tax years may elect not to capitalize (that is, deduct) the cost of improvements if their total expense for maintenance, repairs, and improvements is the lesser of $10,000 or 2 per cent of the building’s unadjusted basis. This allowable expensing of improvements is calculated on a per-building basis.

This safe harbor irrevocable election is made on an annual basis on an original, timely filed return (including extensions). Furthermore, as with many other provisions in these final regulations, taxpayers are allowed to apply this rule to tax years beginning in 2012 or 2013 by amending the affected tax returns.

Most of these accounting method changes will require a Section 481(a) adjustment.

Change in accounting method

It is likely that all taxpayers who use fixed assets in their businesses will be required to make a change in accounting method to comply with them. Most of these accounting method changes will require a Section 481(a) adjustment. The IRS has stated that it will provide a separate set of procedures so that taxpayers will be able to obtain automatic consent to change their method of accounting for years beginning on or after January 1, 2012, to comply with these regulations.

Of course, certain provisions (like the $5,000 de minimis expensing exception for the costs to acquire or produce tangible property) are not a change in accounting method and may be implemented as long as the taxpayer meets the requirements.

New proposed regulations for disposals

The IRS decided not to finalize the temporary regulations for either the disposal of depreciable property or general asset accounts. Instead the IRS has issued new proposed regulations that will affect all disposals of MACRS property. This allows time for additional comments to be made.

According to the earlier 2011 regulations, a taxpayer was allowed to recognize a loss on the disposition of a structural component of a building before the entire building was sold. However, if a building or other asset was placed in a general asset account, the taxpayer did not have to claim a loss on the retirement of a component of an asset (whether structural or other) unless an affirmative election was made to treat the retired component as a qualifying disposition. The new proposed 2013 regulations have revised this provision by creating a “partial disposition election” for assets that are not in general asset accounts. By making this election, the taxpayer is allowed to recognize a loss on the component’s retirement. When the election is not made, the taxpayer continues to depreciate the component. By such wording as to make this an optional election, however, taxpayers are being given much greater flexibility.

Note that although the partial disposition rule is generally elective, this is not the case for certain specified types of dispositions where it is mandatory to recognize a gain or loss. These dispositions are:

- A disposition of part of an asset due to a casualty (Code Section 165).
- A disposition under IRS Code Sections 1031 and 1033.
- The transfer of an asset in a step-in-the-shoes transaction (Code Section 168(i)).
- The sale of a portion of an asset (Prop. Reg. 1.168(i)-8(d)(1)).

The new proposed regulations also modify the rules for general asset accounts. According to the newest guidance, if a portion of an asset is disposed of, it is only included as a disposition if the taxpayer makes an election to terminate the general asset account once all assets in it are disposed.

A benefit of the new rules is that they allow some choice as to when the final rules must be applied.

In conclusion

The final regulations give taxpayers much needed guidance on the correct treatment for various expenditures made on tangible property. Following this guidance will ease the decision-making process for expensing versus capitalizing such costs. In addition to the final regulations, the IRS has reissued new proposed rules for the disposition of MACRS property.

The final regulations simplify and expand the de minimis safe harbor rule that allows the expensing of costs to acquire or produce tangible property, create a new safe harbor for small businesses to expense improvements made to certain buildings, refine the rules for betterments and restorations, extend the safe harbor expensing of routine maintenance costs to buildings, increase the allowable amount of expensing of materials and supplies, and provide for an election to capitalize certain maintenance and repair costs.

While the rules affect all types of industry, they will be especially significant for manufacturing, retail, utility companies, oil and gas, and mining, all of which have a particularly large number of fixed assets.

A benefit of the new rules is that they allow some choice as to when the final rules must be applied. In addition, taxpayers have been given various possible elections that can be made or not. For example, taxpayers should be pleased that having a safe harbor de minimis election to expense up to $5,000 of qualifying property (rather than it being a mandate) allows much more flexibility. Therefore, while the rules are definitely complicated, they provide more opportunity for decision making and tax planning in their application.

To be ready, businesses must assess their current accounting systems, gather needed information and data, decide whether they wish to amend prior year returns and apply the new rules to 2012 or 2013, evaluate the impact of these rules on state and local returns, and prepare for any needed disclosures on their financial statements. The effective date for tax years beginning on or after January 1, 2014, applies to both the final and reproposed regulations. Further guidance in the form of two revenue procedures is expected shortly. And, finally, while some provisions in these regulations can be used as early as 2012, there are certain ones that only apply to years beginning on or after January 1, 2014 (such as the election to capitalize maintenance and repair costs).

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