SNYDERCOHN
CPAs and Trusted Advisors

Practical Implications of the New Repair Regulations

The following pages contain an issues-based summary of some of the provisions of the recently issued Treasury regulations under §§ 263, 162, 167, and 168 of the Internal Revenue Code (the "repair regs"). We believe it will be helpful in understanding some of the concepts and provisions discussed in the regs and in raising awareness of important issues.

The regulations are generally effective for tax years beginning on or after January 1, 2014. In this summary, we have focused on issues that need to be addressed beginning in 2014. Consequently, we have not included any discussion about whether or when taxpayers might have to file an application for a change in accounting method. If required, the form would not have to be filed until 2015 at the earliest, and we expect additional guidance from the Service prior to that time.

Please keep in mind that the regulations are long and complicated, and how to apply them requires a significant amount of consideration and judgment. Because this is a summary, it cannot, nor is it intended to, cover every provision, detail, or exception contained in the regs.

We encourage you to contact us with any questions about how the new regulations apply to your business generally, or to any specific situation or transaction.

Also, the IRS wants us to tell you this:

What has to be capitalized under the regulations?

1. New assets, unless they qualify as materials and supplies or fall under the de minimis provisions:
    a. Generally, assets are materials and supplies if they have a useful life of 12 months or less OR if they have a per unit cost of $200 or less
    b. The de minimis rule allows expensing of assets if:
        i. The client has a capitalization policy in effect at the beginning of the year
        ii. The per unit cost of the asset is no more than:
            1. $5,000 if the client has audited financial statements for the year the asset was placed in service, or
            2. $500 if the client doesn't have audited financial statements
2. Amounts paid to facilitate the acquisition or production of property must also be capitalized.
    a. The regulations provide examples of costs that are considered "inherently facilitative"
    b. Other costs incurred in the investigating/pursuing the acquisition of property are also facilitative and have to be capitalized
3. Amounts paid to improve tangible property. Property is improved if the amounts paid result in:
    a. A betterment to the property (discussed separately)
    b. A restoration of the property (discussed separately)
    c. An adaptation of the property to a new or different use (discussed separately)
4. Amounts paid to repair the property will generally be currently deductible if the "repair" does not result in an improvement, as defined in paragraph 2.
5. Other exceptions:
    a. Amounts that fall under the routine maintenance safe harbor (discussed separately) do not have to be capitalized
    b. Amounts that fall under the small business safe harbor (discussed separately) do not have to be capitalized

The regulations generally make determinations of whether an activity is a repair (deductible) or an improvement (capitalized) based on the concept of a "unit of property." What is a unit of property?

1. For most personal property, all "functionally interdependent" components constitute a single unit of property. Components are considered functionally interdependent if "the placing in service of one component … is dependent on the placing in service of the other component." Under examples in the regs:
    a. A locomotive is a single unit of property, but
    b. A computer and printer are two separate units of property
2. A building and its structural components are a single unit of property; however, for purposes of determining whether work on the building constitutes an improvement, each of the following are treated as if they were separate units of property:
    a. The building structure
    b. HVAC systems
    c. Electrical systems
    d. All of the building's elevators
    e. All of the building's escalators
    f. Fire protection and alarm systems
    g. Security systems
    h. Gas distribution systems
    i. Other components identified in (future) IRS guidance
3. For a condominium or cooperative, the unit of property is the portion owned by the taxpayer. The improvement rules are applied in the same way as if the unit were a complete building; i.e., each building system (or the part of each building system owned by the taxpayer) has to be considered separately
4. If a taxpayer is leasing a portion of a building, the portion of the building leased is the unit of property. If a taxpayer is leasing two distinct areas within a building under separate leases, there are two units of property. For the purposes of improvements, building systems must be considered separately, as in paragraphs 2. and 3.
5. If an amount is expended to improve a unit of property, the improvement becomes part of the unit of property for future determinations of what is a repair or an improvement; however, the improvement must still be depreciated separately.

What constitutes a betterment of a unit of property?

1. Amounts expended are considered betterments if they accomplish any of the following:
    a. Amelioration of “a material condition or defect that either existed prior to the acquisiton of the unit of property or arose during the production of the unit of property”
    b. A material addition, “including a physical enlargement, expansion, extension, or addition of a major component, or a material increase in capacity”
    c. A material increase in the “productivity, efficiency, strength, quality, or output of the unit of property”
2. Defects that arise after the acquisition or production of the property, during the taxpayer’s use of the property can be repaired without capitalization, provided the repair doesn’t include an addition or a material increase in productivity, etc.
3. In determining whether an addition or increase is material, the point of comparison is either to the property before the defect arose or to the property when it was placed in service, NOT to the capacity, productivity, etc. of the property immediately before the repair/improvement
4. Under examples in the regulations, a 10% improvement in capacity (measured against the capacity when the property was originally placed in service and in good working order) resulting from a repair (because original replacement parts weren’t available, and an upgraded part had to be used) was NOT considered material, and the related expenditure did not have to be capitalized

What constitutes a restoration of a unit of property?

1. An amount expended by the taxpayer restores a unit of property if it is:
    a. for the replacement of a component for which the taxpayer has previously recorded a gain/loss on the disposition, abandonment, etc.
    b. to return the property to ordinary operating condition if the property "has deteriorated to a state of disrepair and is no longer functional for its intended use"
    c. to rebuild the property to a "like-new condition" after the end of the property's class life
    d. for the replacement of a part or parts that comprise "a major component or a substantial structural part" of the property
2. Note that substantial maintenance of property that is still functioning, even in a reduced capacity, is often deductible whereas very similar maintenance would be required to be capitalized if the property has ceased to perform its usual function
    a. However, the repair of an incidental part of the property may still be deductible, even if it's required to make the property functional. The example given in the regs is the replacement of a power switch assembly on a drill press. This was not considered a restoration.
3. Whether something is a "major component or substantial structural part" of property is determined using all of the facts and circumstances. Some inferences can be made from examples in the regulations:
    a. The replacement of an entire roof was considered a restoration, but the replacement of a roof membrane was not.
    b. The examples include an HVAC system repair where the HVAC system included ten roof-mounted heating and cooling units. The replacement of three of the ten units was not considered "a significant portion of a major component" of the system, so the replacement was not considered a restoration. Note that in this case, the HVAC system was still functioning, albeit suboptimally.
    c. Similarly, replacing 30% of a building's wiring was not considered the replacement of a "substantial" part of the building's electrical system.
4. A "like-new condition" is a fairly high standard. The regs include an example where very substantial and costly maintenance was performed on aircraft after the end of its class life, in order to keep it functional and in compliance with FAA requirements. The maintenance was not considered a restoration because the aircraft was still operational prior to the maintenance, and the aircraft was not restored to a like-new condition.

What constitutes an adaptation to new use?

1. “An amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer’s ordinary use of the unit of property at the time originally placed in service by the taxpayer.”
2. Here again, the determination of “consistent with the taxpayer’s ordinary use” is subjective and must consider all of the facts and circumstances. From the examples in the regs:
    a. The reconfiguration of retail spaces within a leased building by a lessor to accommodate different retail lessees was not considered a new or different use.
    b. The reconfiguration of a pharmacy building to create a walk-in medical clinic was considered an adaptation to new use.
    c. The reconfiguration of a grocery store to add a sushi bar was not considered an adaptation to new use.
3. Note that in most of the examples, the taxpayer also acquired new personal/§1245 property, and the new property was treated separately as additional units of property which had to be capitalized and depreciated separately.

What about leased property?

1. Generally speaking, the same rules that apply to purchased property apply to leased property. The determination of whether an expenditure is for a repair or for an improvement follow the same principles.
2. If a lessee funds the improvements, then the lessee capitalizes the improvements
3. If the lessor pays for improvements, the lessor capitalizes the improvements.

What is the routine maintenance safe harbor?

1. Amounts incurred under the routine maintenance safe harbor are deemed to NOT be improvements (i.e., they are currently deductible)
2. Routine maintenance is “recurring activities that a taxpayer expects to perform as a result of the taxpayer’s use [of a unit of property] to keep the property in its ordinarily efficient operating condition”
3. Activities falling under routine maintenance can be substantial and can include the replacement of worn or damaged parts with “comparable and commercially available replacement parts.”
4. In order for the activities to qualify as routine, the taxpayer must reasonably expect to perform them more than once during
    a. A period of ten years, for buildings
    b. The class life of the property, for non-building property
5. Expenditures that do not fall under the routine maintenance safe harbor do not automatically have to be capitalized: they can still be expensed if they qualify as a repair rather than an improvement under the other provisions of the regulations.
6. There are some exceptions. The following don’t constitute routine maintenance:
    a. Any amount paid for a component that the taxpayer has previously recorded a gain/loss on the disposition of
    b. Amounts paid to restore the unit of property to an operational condition if the unit of property is in disrepair and is no longer functional for its intended use
    c. Amounts that qualify as a betterment or an adaptation to new use of the unit of property

What is the small business safe harbor?

1. The small business safe harbor is a special de minimis provision that applies to building property.
2. The taxpayer must be a "small taxpayer" (average annual gross receipts of <$10Million)
    a. Average annual gross receipts are calculated over a period of three years
    b. Gross receipts are calculated under rules similar to other code provisions dealing with gross receipts
3. The amount paid during the tax year for repairs, maintenance, improvements, etc. cannot exceed the lesser of:
    a. 2% of the unadjusted basis of the building property
    b. $10,000
4. The limitation and election are applied on a property-by-property basis
    a. The safe harbor is available for any property where expenses don't exceed the 2%/$10,000 limit, even if some properties don't qualify
    b. Taxpayers with multiple properties can elect to use the safe harbor for some qualifying properties and not for others
5. For leased buildings or portions of buildings, the unadjusted basis of the building property is the total amount of lease payments to be paid over the term of the lease (including lease extensions that are likely to be exercised)
6. The taxpayer has to elect the safe harbor by attaching a statement to its return for the year(s) the safe harbor is used

What about partial dispositions of building property?

1. Newly **proposed** MACRS regulations allow taxpayers to recognize gain or loss on the disposition of some part of building property
    a. The disposition could be of an entire building system (e.g., all of the elevators) or of a component of a building system (e.g., one of the elevators)
    b. The provisions are mandatory in certain situations (casualty losses and some other nonrecognition provisions) but must be elected in others
2. In general, if a taxpayer decides to report a gain/loss on a partial disposition of property, then the replacement property will have to be capitalized.
3. The election to treat a partial disposition as the disposition of a separate asset is made by reporting the disposition and any gain/loss on the taxpayer's return
4. In many cases, the adjusted basis of property disposed in a partial disposition will not be readily or separately determinable
    a. The regulations provide that a taxpayer may use any reasonable method to determine the unadjusted basis of the disposed component
    b. Reasonable methods include discounting the cost of the replacement property to the in-service date of the disposed property using the CPI
    c. Pro forma depreciation is calculated on the unadjusted basis of the disposed property as if it had been a separate asset and deducting the calculated depreciation from the unadjusted basis.