Impact of the final 'repair' regulations on the retail industry

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In brief

The IRS and Treasury Department recently released final regulations regarding the deduction and capitalization of expenditures related to tangible property (the 'final regulations'), as well as re-proposed regulations regarding the disposition of tangible depreciable property (the '2013 proposed regulations'). Collectively, these regulations are meant to help taxpayers better distinguish between currently deductible repair and maintenance expenses under Section 162(a) and expenditures that must be capitalized under Section 263(a), and provide them with more guidance regarding dispositions, including partial dispositions. For tax years beginning on or after January 1, 2014, retailers will need to evaluate the impact of these new regulations on their businesses.

In detail

Background

Final regulations are issued

The recently issued final regulations retain many of the same provisions from the temporary regulations issued in December 2011 (the '2011 temporary regulations'), but also refine and simplify some of the rules. As a result, the final regulations will require taxpayers, including retailers, to analyze their current methods of accounting in light of the new rules.

Upon analyzing their current methods of accounting, many taxpayers may discover that they need to file a Form 3115, *Application for Change in Accounting Method*, in order to comply with the final regulations. A change in method of accounting under the final regulations generally requires a Section 481(a) adjustment. However, certain provisions are implemented on a cut-off basis, rather than with a Section 481(a) adjustment, which means those methods of accounting only apply to amounts paid or incurred in tax years beginning on or after January 1, 2014. The overall impact of the final regulations will depend on a taxpayer's specific facts and circumstances.

Implementation timing and options

All taxpayers must comply with the final regulations beginning with their first tax year that begins on or after January 1, 2014. However, taxpayers have several implementation options with respect to tax years beginning on or after January 1, 2012, and on or before January 1, 2014. For any such tax year, a taxpayer may (1) continue with its existing methods of accounting, (2) early adopt the 2011 temporary regulations, (3) early adopt the final regulations, or (4) any combination of the prior three options.

Pending revenue procedures

The preamble to the final regulations confirms that the IRS will issue separate revenue procedures, providing procedures by which taxpayers may obtain automatic consent to change their methods of accounting to comply with the final regulations for tax years beginning on or after January 1, 2012. These revenue procedures presumably will provide audit protection for all tax years prior to the tax year for which a taxpayer changes its methods of

accounting to comply with the final regulations, along with other necessary procedural rules. We expect these revenue procedures to be issued in the coming weeks.

Key provisions of the final regulations that may be of particular interest to retailers

Componentization of buildings

Although a building and its structural components generally are treated as a single unit of property (UOP), the improvement standards outlined in both the 2011 temporary regulations and the recently issued final regulations require a different approach. In determining whether an expenditure should be capitalized as an improvement (i.e., betterment, restoration, or adaptation to a new or different use) or deducted as an expense, the improvement standards are applied separately to the components of a building (whether owned or leased), meaning the building structure (e.g., floors or walls) and the specifically defined building systems:

1. Heating, ventilation, and air conditioning (HVAC) systems
2. Plumbing systems
3. Electrical systems
4. Escalators
5. Elevators
6. Fire protection and alarm systems
7. Security systems
8. Gas distribution systems
9. Other structural components identified in published guidance

Accordingly, a cost is treated as a capital expenditure if it results in an improvement to the building structure or to any of the specifically enumerated building systems.

Observation: While the final regulations expand on the examples contained in the 2011 temporary regulations, they still do not significantly clarify the improvement standards, especially with respect to periodic retail store refresh and remodel costs. The analysis of whether store refresh or remodel costs result in an improvement continues to rely heavily on taxpayer specific facts and circumstances. Due to the subjective nature of the improvement standards in the final regulations, retailers may continue to experience uncertainty in this area, even in light of the new routine maintenance safe harbor for buildings (discussed below).

Observation: Soon after the 2011 temporary regulations were issued, the IRS and Treasury Department accepted a request from the retail industry for guidance under the Industry Issue Resolution (IIR) program regarding capitalization versus repair issues. The submission included a specific request to address 1) application of the unit of property rules, 2) repair and remodeling expenses (store refreshes), and 3) rules for general maintenance and repair expenses. Although the final regulations provide guidance with respect to the treatment of store refreshes, the retail industry and the IRS are committed to continuing on with the IIR process and seeing it through to completion.

Routine maintenance safe harbor

The routine maintenance safe harbor in the 2011 temporary regulations is retained in the final regulations, but is significantly modified to include buildings and to increase the list of ineligible costs. Under the safe harbor, amounts paid for routine maintenance on a UOP are not required to be capitalized as an improvement to that property.

Routine maintenance of a building is defined as recurring activities to a building UOP that a taxpayer expects to perform as a result of the taxpayer's use of the building UOP in order to keep (as opposed to put) the building structure or each building system in its ordinarily efficient operating condition. Such activities are considered routine only if, at the time the UOP is placed in service, the taxpayer reasonably expects to perform the activities more than once during the 10-year period beginning when the building structure or building system upon which the routine maintenance is performed is placed in service.

Routine maintenance of property other than buildings is defined as recurring activities to a UOP that a taxpayer expects to perform as a result of the taxpayer's use of the UOP in order to keep (as opposed to put) the UOP in its ordinarily efficient operating condition. Such activities are considered routine only if, at the time the UOP is placed in service, the taxpayer reasonably expects to perform the activities more than once during the class life of the UOP.

Factors to be considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar property.

Observation: The regulations contain a long list of costs for which the routine maintenance safe harbor does not apply, including amounts paid for a betterment to a UOP, for most restorations to a UOP (other than the replacement of a major component or a substantial structural

part), and for adaptations of property to a new or different use. As a result, the expansion of this safe harbor to buildings may only prove useful to retailers in a fairly limited number of circumstances.

Partial dispositions election

Under the 2013 proposed regulations, which are expected to be finalized at the end of 2013 (or early 2014) and effective for tax years beginning on or after January 1, 2014, the disposition rules for assets not included in a general asset account (GAA) would apply to a partial disposition of an asset. This would allow retailers and other taxpayers to claim a loss upon the disposition of a structural component (or a portion thereof) of a building or a component (or a portion thereof) of any other asset without identifying the component as an asset before the disposition event. Further, the rule would minimize instances in which an original part and any subsequent replacement(s) of the same part would be required to be capitalized and depreciated simultaneously.

The partial disposition rule generally would be elective, except in the following cases in which the rule would have to be applied:

- The disposition of a portion of an asset resulting from a casualty event described in Section 165,
- The disposition of a portion of an asset for which gain -- determined without regard to Sections 1245 or 1250 -- is not recognized in whole or in part under Sections 1031 or 1033,
- The transfer of a portion of an asset in a step-in-the-shoes transaction described in Section 168(i)(7)(B), or
- The sale of a portion of an asset.

A taxpayer could elect to apply the partial disposition rule on an asset-by-asset basis for the tax year in which the portion of the asset is disposed. The annual binding election could be made for current-year dispositions of any type of MACRS property, including assets in asset classes 00.11 through 00.4 of Rev. Proc. 87-56.

Observation: The partial disposition election is illustrated in Example 3 of the 2013 proposed regulations. In this example, the partial disposition election is made for an elevator that was replaced in an office building. Although the office building -- including its structural components -- is the asset for disposition purposes, the result of making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. As a result, depreciation for the retired elevator ceases at the time of its retirement (taking into account the applicable convention), and the taxpayer recognizes a loss on retirement. Further, the taxpayer must capitalize the amount paid for the replacement elevator, and the replacement elevator is a separate asset for disposition purposes.

De minimis rule

The final regulations incorporate substantial changes to the de minimis rule provided in the 2011 temporary regulations. The final regulations provide that, for tax purposes, a taxpayer may elect to expense the cost of acquired property that does not exceed a certain dollar amount. The de minimis rule is applied at the invoice or item level, based on the policies that the taxpayer uses for its books and records. The invoice or item dollar limit depends on whether a taxpayer has an applicable financial statement (AFS).

An AFS is defined in the regulations as (1) a financial statement required to be filed with the Securities and Exchange Commission (SEC), (2) a certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for (a) credit purposes, (b) reporting to shareholders, partners, or similar persons, or (c) any other substantial non-tax purpose, or (3) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the Internal Revenue Service). The taxpayer's AFS is the financial statement with the highest priority within the descending list above.

Taxpayers with an AFS are allowed a $5,000 per invoice or item limit, provided that written accounting procedures treating as an expense for non-tax purposes amounts paid for property costing less than a specified dollar amount, or amounts paid for property with an economic useful life of 12 months or less, are in place at the beginning of the tax year, and are being followed. For example, if a taxpayer purchases 10 computers at a cost of $2,000 each for a total of invoice price of $20,000, then the taxpayer would be eligible to elect to use the de minimis rule and expense such computers when purchased, assuming all other requirements of the de minimis rule are satisfied.

Taxpayers without an AFS may apply the de minimis rule if the amount paid for property does not exceed $500 per invoice or item, but no *written* policy is necessary.

Observation: The de minimis rule is a safe harbor that may be elected annually and must be applied to all amounts paid in the tax year for tangible property that meet the requirements of the de minimis rule, including materials and supplies. For many retailers, the de minimis rule

may apply to the purchase of product display cases, storage cabinets, signage, shopping carts, or point-of-sale kiosks and registers, if the cost of such items is not capitalized in an AFS pursuant to written accounting procedures and does not exceed $5,000. It may also apply to hangers, clips, security tags, barcode labels, light bulbs, or other supplies, assuming all other requirements of the de minimis rule are satisfied. Taxpayers may not revoke an election to use the de minimis rule.

Observation: Even if items are not eligible for the de minimis rule because the cost of such items is capitalized in the taxpayer's AFS, the items may qualify as materials and supplies under the final regulations (e.g., because the economic useful life of the item is 12 months or less, or the cost is $200 or less). The cost of materials and supplies may be taken into account in the year of purchase (incidental) or in the year first used or consumed in the taxpayer's operations (non-incidental), provided taxable income is clearly reflected. Therefore, retailers should determine whether any items that are currently capitalized meet the definition of materials and supplies and could be deducted in an earlier year. For example, assume a retailer that currently capitalizes and depreciates shopping carts determines that the cost of each shopping cart is $200 or less. Under the final regulations, the shopping carts can be treated as materials and supplies for tax purposes and be deducted in the year they are first used by the retailer.

Observation: Because the de minimis rule is a safe harbor, taxpayers can still rely on case law if they do not satisfy the requirements of the safe harbor. Furthermore, the preamble states that, if an examining agent and a taxpayer agree that certain amounts in excess of the de minimis rule limitations are immaterial and should not be subject to review, then that agreement should be respected, notwithstanding the requirements of the de minimis rule. However, the preamble also states that taxpayers seeking a deduction for amounts in excess of the amount allowed by the de minimis rule will have the burden of showing that such treatment clearly reflects income.

Action items for retailers

Create a tailored implementation workplan

Retailers should determine what their strategic goals are with respect to the final regulations and then create a tailored implementation workplan. A tailored workplan may help taxpayers: (1) comply with the final regulations; (2) improve internal systems and processes that relate to fixed assets; (3) identify expenditures that can be currently deducted; (4) evaluate available elections, safe harbors, and optional methods of accounting; (5) enhance net operating loss carrybacks; (6) manage expiring foreign tax credits and other tax attributes; or (7) account for potential tax rate changes.

Review current accounting methods and prior year repairs studies

The final regulations generally require a Section 481(a) adjustment, which means taxpayers must review their current accounting methods and prior year repairs studies in order to comply with the new rules. Based on the new rules, some retailers may find that they have over-capitalized their repair expenditures, while others (especially those that previously filed a repairs method change) may find that they have over-deducted them. In either case, taxpayers should consider filing a Form 3115. By doing so, those that have over-capitalized their repair expenditures will receive an additional benefit through a cumulative catch-up adjustment, while those that have over-deducted their repair expenditures will most likely receive audit protection for prior years. Taxpayers that have over-deducted their repair expenditures and are required to recapture disallowed deductions should be especially vigilant in understanding the impact this might have on cash flow assumptions and estimated tax payment obligations.

Evaluate the need for systems enhancements

The rules contained in the final regulations will require many retailers to evaluate the adequacy of certain systems. For example, the UOP and de minimis rules will require taxpayers to consider how expenditures that may need to be capitalized for federal income tax return purposes will be tracked to the extent they are not capitalized for financial statement purposes. Similarly, the disposition rules that impact building assets will require additional attention in order to ensure that adjusted tax basis associated with partial dispositions is properly taken into account.

Monitor IIR progress, but keep moving forward

Although the retail IIR program related to repairs has been under way for almost 18 months, it is unclear when specific industry guidance will be issued. Accordingly, retailers should move forward with their analysis of the final regulations while continuing to monitor IIR progress.

The takeaway

With the release of the final regulations, retailers will need to analyze their current methods of accounting in light of the new rules. However, a one-size-fits-all approach to doing so generally is not appropriate. Every taxpayer is different. Some taxpayers are in a taxable income position, while others

are in a loss position. In addition, some taxpayers have previously filed a repairs method change, while others have not. Furthermore, some taxpayers are interested in planning opportunities, while others are more focused on compliance obligations and minimizing book-tax differences. These and other factors should be taken into account when determining how to analyze and implement the final regulations.

Additional resources

Readers wanting more information on the final regulations are encouraged to refer to the following WNTS Insights:

- Final tangible property repair regulations: Effective dates, materials and supplies, de minimis rule, and rotable spare parts
- Final tangible property repair regulations: Unit of property and acquisition or improvement of property
- Final tangible property repair regulations and proposed regulations: Dispositions, general asset accounts, recovery of certain capital improvements, and removal costs

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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