Final tangible property repair regulations: Unit of property and acquisition or improvement of property

September 26, 2013

In brief

This is the second WNTS Insight in a three-part series that discusses in depth the recently issued final regulations regarding the deduction and capitalization of expenditures related to tangible property (final repair regulations). The first Insight discussed rules related to effective dates, materials and supplies, the de minimis rule, and rotable spare parts. (See WNTS Insight, "Final tangible property repair regulations: Effective dates, materials and supplies, de minimis rule, and rotable spare parts," September 18, 2013.) This Insight focuses on rules related to the unit of property and acquisition or improvement of property. The third Insight will include a discussion of dispositions, general asset accounts, the recovery of capital improvements subject to lease, and removal costs.

In detail

Unit of property

The 2011 temporary regulations generally defined a unit of property (UOP) as consisting of all components that are functionally interdependent. Special rules were provided for buildings and their structural components, plant property, and leased property. The 2011 temporary regulations did not provide a definition of UOP for network assets. As discussed below, the final repair regulations generally retain the UOP rules from the 2011 temporary regulations.

Buildings and structural components

The final repair regulations provide that a UOP for a building is comprised of the building and its structural components. However, taxpayers must apply improvement standards separately to the building structure and to each specifically defined building system. Building systems are defined to include only:

- 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 systems identified in published guidance.

A roof, while not explicitly referenced in the definition of a UOP in the final repair regulations, is included in the meaning of building structure under the investment tax credit regulations (Reg. sec. 1.48-1(e)(1)) and thus incorporated by reference into the definition of a building in the final repair regulations.

With respect to a condominium, the UOP is the individual unit owned by the taxpayer and the structural components that are part of the condominium unit. Similarly, for a taxpayer that has an ownership interest in a cooperative housing corporation, the UOP is the portion of the building in which the taxpayer has possessory rights and the structural components that are part of the portion of the building subject to the taxpayer's possessory rights.

Observation: The final repair regulations continue to provide for the "componentization" of a building into multiple UOPs. As seen with the 2011 temporary regulations, this is a significant change from prior law, under which many taxpayers likely treated the building inclusive of all the aforementioned building systems as a single UOP. These UOP definitions, combined with the imposition of a section 481(a) adjustment to conform to the final repair regulations, will require taxpayers to analyze all their buildings to determine the impact of the new UOP rules on prior-year repair expenditures.

Observation: The IRS notes in the preamble to the final repair regulations that to the extent the particular facts and circumstances of particular industries present unique challenges to the application of the building structure or building systems definitions, taxpayers are encouraged to request guidance under the IIR program. The IRS already has issued guidance for several industries under the IIR program and expects to issue more guidance in the coming years.

Property other than buildings

The final repair regulations retain the functional interdependence test, which provides the general rule for determining the UOP for real and personal property other than buildings, such as manufacturing equipment, office equipment and furniture, and vehicles. Components of property are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component.

However, special rules are provided to determine the UOP for certain property other than buildings, including:

- *Plant property:* The final repair regulations retain the rule that the UOP for plant property used to perform an industrial process generally is comprised of each component (or group of components) within the plant that performs a discrete and major function or operation within functionally interdependent machinery and equipment.
- *Network assets*: The final repair regulations retain the operative rule that the UOP for “network assets” such as pipelines and cable lines is determined by the taxpayer's particular facts and circumstances except as otherwise provided in published guidance. Thus, the functional interdependence test is not determinative for network assets; previously issued guidance on network assets, such as telecommunications network assets, is not modified by the final repair regulations.
- *Leased property other than leased buildings*: The final repair regulations retain the rule that the lessee's UOP for leased real or personal property other than building property is determined under the general rules for property other than buildings, including the functional interdependence test and the plant property rule (as applicable), except that, after applying those rules, the UOP may not be larger than the property subject to lease.
- *Improvements*: Improvements to a UOP generally are not a UOP separate from the UOP improved. See exception below regarding lessee improvements.

Observation: The application of these UOP standards for property other than buildings may result in larger UOPs than those used for financial accounting purposes. Accordingly, taxpayers following their financial accounting method and applying improvement standards to a smaller unit of property may be capitalizing deductible repair expenditures.

UOP for leasehold improvements of lessee

The final repair regulations retain the rules provided in the 2011 temporary regulations with respect to the UOP for a lessee’s leasehold improvements, but provide some clarifications. Under both the 2011 temporary and final repair regulations, an amount paid for a lessee improvement is treated as an amount paid to acquire or produce a UOP, but the lessee’s UOP may not be larger than its leased portion of the building, if less than the whole building.

The IRS and Treasury were concerned that the 2011 temporary regulations could have suggested that a taxpayer could determine whether there has been an improvement to a leasehold improvement by itself, rather than by applying the improvement standards to the general UOP rules for buildings and for property other than buildings, as applicable. Thus, the final repair regulations clarify that for purposes of determining whether an amount paid by a lessee constitutes a leasehold improvement, the UOP and the improvement rules are applied in accordance with the rules for leased buildings (or portions of leased buildings) or for leased property other than buildings, as applicable, and include previous leasehold improvements.

That is, amounts initially capitalized as a lessee improvement are treated as a cost of acquiring or producing a UOP and constitute a UOP separate from the leased property being improved. However, subsequent expenditures still are analyzed based on the leased property and previous leasehold improvements in accordance with the general rules.

The final repair regulations also clarify that when a lessee improvement is comprised of a building erected on leased property, the UOP for the building and the application of the improvement rules are determined under the provisions for buildings, rather than the provisions for leased buildings.

UOP depreciation consistency rule

The final repair regulations retain the so-called “depreciation consistency rule,” which provides that a component of a UOP must be treated as a separate UOP if the taxpayer has properly treated the component as being within a different MACRS class than the class of the UOP of which the component is a part or if the taxpayer has properly depreciated the component using a different depreciation method than the depreciation method for the UOP of which the component is a part.

Further, if a taxpayer or the IRS properly changes the MACRS class or depreciation method for any type of property in a tax year after the year the property was initially placed in service, then the taxpayer must change the UOP determination for that property to be consistent with the change in treatment for depreciation purposes.

Acquisition or production of new property

In general, the final repair regulations retain the general rules from the 2011 temporary regulations with respect to the requirement to capitalize amounts paid to acquire or produce real or personal property and to defend or perfect title to real or personal property, including the invoice cost, transaction costs, and the cost of work performed prior to the date the property is placed in service.

In addition, the final repair regulations contain the same general framework for determining the extent to which taxpayers must capitalize “transaction costs” related to the acquisition, as well as the special exceptions for internal costs and for amounts paid to investigate the acquisition of real property.

Transaction costs

As noted above, the final repair regulations retain many of the transaction cost concepts provided in the 2011 temporary regulations. In general, amounts paid to facilitate the acquisition of a UOP must be capitalized. The final repair regulations provide that facilitative costs generally include amounts paid in the process of investigating or otherwise pursuing the acquisition. Whether costs are facilitative is based on the facts and circumstances of the acquisition.

The final repair regulations also retain the list of inherently facilitative costs that generally must be capitalized as transaction costs. However, in response to comments seeking clarification, the final repair regulations clarify and modify the meaning of contingent finders’ fees and brokers’ commissions paid to acquire or produce tangible property. Specifically, a taxpayer must capitalize such contingency fees that are contingent on the successful closing of the acquisition, and may not allocate such fees to property not acquired.

Observation: Transaction costs must be capitalized even if the real or personal property is not acquired in the period the costs are incurred. If the acquisition is abandoned, the costs may be recovered as a loss under Section 165.

Internal costs

The treatment of employee compensation and overhead costs related to transactions has not changed from the 2011 temporary regulations. Accordingly, amounts paid by a taxpayer for employee compensation and overhead costs are not treated as facilitative costs unless the taxpayer elects to capitalize those costs. The election may be for either or both types of costs, and is made on a transaction-by-transaction basis.

Real property investigatory costs

Both the temporary and final repair regulations provide that activities performed by a taxpayer to determine whether to acquire real property, and which real property to acquire, are not required to be capitalized unless the cost is considered an inherently facilitative cost. Therefore, such pre-decision investigatory costs for real property generally need not be capitalized.

The final repair regulations provide that a taxpayer may use a reasonable allocation method when real and personal property are acquired as part of a single transaction. An allocation will allow taxpayers to deduct investigatory costs related to the acquisition of real property, while capitalizing such costs related to the acquisition of personal property.

Note: Some commentators requested that the deduction allowed for investigatory costs be extended to personal property. The preamble to the final repair regulations explains that the deduction for investigatory costs was not extended to personal property because, unlike real property acquisitions, personal property acquisitions do not typically raise issues of whether the transaction costs should be characterized as deductible business expansion costs rather than costs to acquire specific property. In addition, the IRS notes that personal property acquisitions typically do not provide clear evidence establishing the timing of decisions, so a rule to expand the deduction for investigatory costs to personal property could create significant controversy over relatively small amounts.

Amounts paid to improve tangible property

The final repair regulations address whether an expenditure results in an improvement of tangible property and thus must be capitalized. Generally, a UOP has been improved if the activities performed on the property:

- Result in a betterment to the UOP (betterments);
- Restore the UOP (restorations); or
- Adapt the UOP to a new or different use.

Observation: In general, these standards reflect historic capitalization principles that developed when courts and the IRS interpreted the previous regulatory requirements that an expenditure must be capitalized if it materially increases the value of property, substantially prolongs the life of property, or adapts property to a new or different use. Inherent in these frameworks is the "put versus keep" test developed by the courts under which an expenditure must be capitalized if it “puts” the UOP into an ordinarily efficient operating condition, but generally is deductible if it “keeps” the UOP in its ordinarily efficient operating condition. See, e.g., *Estate of Walling v. Commissioner*, 373 F.2d 190, 192-193 (3d Cir. 1966).

Observation: Although this capitalization framework requires a detailed analysis of a taxpayer’s facts and circumstances, the IRS and Treasury have provided several safe harbors and simplified conventions in an attempt to alleviate the compliance burden, including the new safe harbor for small taxpayers, the new election to capitalize repair and maintenance costs that are capitalized for books, the routine maintenance safe harbor, and the regulatory method safe harbor, all of which are discussed in more detail below.

Betterment

Consistent with the 2011 temporary regulations, the final repair regulations provide that an expenditure results in a betterment, and thus must be capitalized as an improvement, if it:

- Ameliorates a material condition or defect that either existed prior to the taxpayer’s acquisition of the UOP or arose during the production of the UOP, whether or not the taxpayer was aware of the condition or defect at the time of production or acquisition;
- Results in a material addition (including a physical enlargement, expansion, or extension) to the UOP; or
- Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the UOP or the output of the UOP.

Observation: Although many commentators requested quantitative bright line rules for applying these betterment standards, the IRS and Treasury rejected this suggestion because they believed bright-line rules would produce inconsistent results given the broad array of factual settings. Nonetheless, the inclusion of numerous examples applying the betterment standard gives insights into the quantitative application of the qualitative tests. For example, several examples indicate that an increase of 50 percent or more in an applicable factor is material (see Examples 14, 15, 17, and 21), while an increase of 10 percent of less in an applicable factor is not material (see Example 20).

Observation: The final repair regulations remove the non-exclusive list of factors to consider, including, in particular, the treatment of the expenditure in the taxpayer’s financial statements.

Observation: The examples also give insight into how the IRS views store refreshes and remodels performed by retailers. In Example 6, a “refresh” of retail stores to maintain the store’s appearance and functionality that involved cosmetic and layout changes to the store’s interiors and general repairs to modernize the building and reorganize merchandise displays, and that kept the stores in ordinarily efficient operating condition, was not a betterment. By comparison, in Example 8 a “remodel” of retail stores to upgrade the stores to offer higher-end products to a different type of customer, and that involved substantial work to the building’s structures and systems that resulted in material additions and material increases in quality, must be capitalized as a betterment. Note the final repair regulations modified Example 8 to no longer capitalize all refresh costs from Example 6 (which also were undertaken in Example 8) under the theory that such costs were directly related to and incurred by reason of the remodel.

Appropriate comparison

The final repair regulations retain the provisions that a taxpayer must compare the condition of the property immediately after the expenditure to the condition of the property immediately prior to the circumstances that necessitated the expenditure to determine whether there has been a betterment. However, the final repair regulations clarify this standard to specify that the appropriate comparison rule applies only to wear, tear, or damage that occurs during the taxpayer's use of the property.

Thus, if the expenditure is to correct for normal wear and tear, then a taxpayer must compare the condition of the UOP after the expenditure to the condition of the property immediately following the taxpayer's previous expenditure for normal wear and tear, or if no prior wear-and-tear work has been performed by the taxpayer, to the condition of the property when it was placed in service. Similarly, if the expenditure is made to correct damage to the UOP that occurred during the taxpayer's use of the UOP, the taxpayer must compare the condition of the UOP after the expenditure to the condition of the UOP immediately prior to the damage.

Observation: The appropriate comparison rule for a UOP when a particular event necessitates the expenditure effectively adopts the so called Plainfield-Union test set forth in *Plainfield Union v. Commissioner*, 39 T.C. 333, 338 (1962).

Pre-existing defect

Similar to the 2011 temporary regulations, the final repair regulations generally provide that the cost to ameliorate a pre-existing defect must be capitalized regardless of whether the taxpayer was aware of the condition or defect at the time of acquisition or production of the UOP. In effect, purchasing property with a pre-existing defect reflects that an improvement was necessitated. The final repair regulations continue to provide examples of what is, and what is not, considered amelioration of a pre-existing material condition or defect.

Note: The IRS received many comments suggesting changes to the requirement to capitalize costs to ameliorate a pre-existing defect but made no changes to this rule. In particular, the IRS did not allow deduction of such expenditure in cases in which the taxpayer was unaware of the defect upon acquisition or production, noting in the preamble to the final repair regulations that the rule provided is consistent with case law and represents an administrable standard for determining whether an improvement has occurred.

Restoration

Following the restoration standards set forth in the 2011 temporary regulations, the final repair regulations generally provide that a taxpayer must capitalize amounts paid to restore a UOP, including amounts paid in making good the exhaustion for which an allowance is or has been made.

An amount is paid to restore a UOP if it:

- Is for the replacement of a component of a UOP and the taxpayer has properly deducted a loss for that component (other than a casualty loss under Reg. sec. 1.165-7);
- Is for the replacement of a component of a UOP and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- Is for the restoration of damage to a UOP for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under Section 165, or relating to a casualty event described in Section 165, subject to limitation (see below);
- Returns the UOP to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and was no longer functional for its intended use;
- Results in the rebuilding of the UOP to a like-new condition after the end of its class life; or
- Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the UOP.

Observation: In general, the first three criteria reflect the fact that the IRS and Treasury do not want a taxpayer to both claim a loss or basis and also deduct the replacement as a repair. Thus, replacements for which the taxpayer claimed a loss or basis are treated like an acquisition of new property, and the amounts paid for the replacement or restoration of the entire property (or components of that property) are treated as capital expenditures that are recovered through depreciation over the proper recovery period. That is, the damaged property is treated as retired, the basis attributable to the damaged property is recovered, and the property that replaces the damage property is capitalized. The remaining three criteria reflect historic capitalization principles embodied in case law.

Salvage value

With regard to replacement of a component of a UOP, the final repair regulations provide a new exception for property that cannot be depreciated to an adjusted basis of zero due to the application of salvage value (e.g., assets that are not depreciated using ACRS or MACRS). Under this exception, taxpayers are not required to treat amounts paid for the replacement of the component as a restoration when a loss is properly deducted or the adjusted basis of the component is realized from a sale or exchange, and the amount of loss or adjusted basis is attributable only to the remaining salvage value. Amounts subject to this exception must be evaluated under other provisions of the final repair regulations to determine whether they are considered improvements to tangible property.

Casualty losses

The final repair regulations modify the casualty loss rule provided in the 2011 temporary regulations and provide examples to illustrate application of the new rule. Consistent with the 2011 temporary regulations, taxpayers still must capitalize amounts paid to restore a UOP if the restoration relates to damage to the UOP for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under Section 165, or relates to a casualty event described in Section 165.

However, under the final repair regulations, the costs required to be capitalized as a restoration under the casualty loss rule are limited to the excess of the adjusted basis of the UOP damaged in the casualty over the amounts paid to restore damage to the UOP that also constitute a restoration under the criteria provided above (excluding the casualty loss rule). Expenditures related to casualties in excess of the limitation are not treated as restoration costs and may be deducted if they otherwise constitute ordinary and necessary business expenses under Section 162.

Observation: In effect, the new casualty loss rule -- which allows a taxpayer to capitalize amounts as a restoration only to the extent of the adjusted basis of the property destroyed in a casualty (generally the amount that also would be recognized as a loss), and deduct any excess expenditures if otherwise deductible (e.g, not a betterment and not adapting property to a new or different use) -- will allow a taxpayer to claim a tax deduction or loss for the full amount of the amount paid to correct the damage. As a result, the new rule eliminates the need under the 2011 temporary regulations to elect to forgo a casualty loss (through use of general asset accounts (GAAs)) in order to claim a deduction for repairs resulting from a casualty.

Rebuild to like-new condition

Like the 2011 temporary regulations, the final repair regulations provide that a UOP is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications. However, the final repair regulations clarify that generally a comprehensive maintenance program, even though substantial, does not return a UOP to like-new condition.

Observation: The final repair regulations also contain two new examples in which activities are performed after the end of the class life, presumably to highlight that not all activities performed after the end of the class life must be treated as restorations. Contrast Example 7, in which rebuilding a freight car to a like-new condition after the end of the class life resulted in a restoration, with Example 8, in which heavy maintenance activities on an airframe performed after the end of the class life but that did not rebuild the property to a like-new condition or involve replacements of major components or substantial structural parts, did not constitute a restoration.

Major component or substantial structural part

The final repair regulations clarify the major component rule included in the 2011 temporary regulations by adding new definitions for major components, substantial structural parts, and major components and substantial structural parts of buildings, and by providing additional examples. Specifically, the final regulations provide:

- A *major component* is a part or combination of parts that perform a discrete and critical function in the operation of the UOP. An incidental component of the UOP, even if such component performs a discrete and critical function in the operation of the UOP, generally will not, by itself, constitute a major component.
- A *substantial structural part* is a part or combination of parts that comprises a large portion of the physical structure of the UOP.
- A *major component and substantial structural part of a building* includes a part or the combination of parts that:
  - Comprises a major component or a *significant portion of a major component* of the building

structure and any building system, or

- Comprises a *large portion of the physical structure* of the building structure or any building system.

Thus, the definition of a major component or a substantial structural part of a building introduces an additional level of analysis related to a *significant portion* of a major component or a *large portion* of a substantial structural part that must be applied in determining whether an amount spent on a building constitutes a restoration.

Observation: Prior to this clarification, the 2011 temporary regulations and examples could have been read to imply that the entire major component or substantial structural part of a building or building system must be replaced to have a capitalizable restoration. See, for example, Example 19 (replacing the entire sprinkler system), Example 20 (replacing all the wiring), and Example 22 (replacing all the plumbing fixtures). These additional standards likely will add an additional level of complexity to the restoration analysis, despite the additional examples included in the regulations.

Observation: The final repair regulations continue to provide only an analytical framework and take a facts-and-circumstances approach as used by the courts to determine whether property replaced is a major component or substantial structural part, despite commentators requests for bright lines. Nonetheless, changes to the examples in the final repair regulations include many quantitative facts that give insight into the IRS and Treasury's view as to whether a replacement rises to the level of a capitalizable restoration. For instance, with respect to major components of buildings or building systems, the examples imply that a replacement of 40% or less of a major component may not be a significant portion of the major component, and thus not a restoration. See, for example, Examples 18, 21, 23, and 25. Other examples imply that a replacement of 66% or more likely is a significant portion of a major component, and thus a restoration.

Similarly, the examples also provide quantitative insight into what is considered a large portion of a substantial structural part. Compare Example 30 -- in which a replacement of 25% of the building structure was not considered a large portion of a substantial structural part and thus not a restoration -- with Example 27, in which a replacement of 30% of the building structure was a large portion of a substantial structural part and thus a restoration. While these examples cannot be read to create bright lines, they will provide assistance in analyzing a taxpayer's individual facts.

Adaption to a new or different use

The final repair regulations retain the substantive rules of the 2011 temporary regulations that provide that taxpayers must capitalize amounts that adapt a UOP to a new or different use. An amount is paid to adapt a UOP to a new or different use if the adaptation is inconsistent with the taxpayer's intended, ordinary use of the UOP at the time it was originally placed in service by the taxpayer.

Observation: The proper determination of whether an amount must be capitalized because it is paid to adapt a UOP to a new or different use continues to depend on the facts and circumstances of the particular taxpayer. While the focus of any analysis under the final repair regulations generally should be limited to the specific facts and circumstances at hand, taxpayers likely will consider taking into account any broadly accepted industry norms when evaluating what is considered "ordinary use" of a UOP. Doing so may help the taxpayer better evaluate whether an amount is paid to adapt a UOP to a new or different use.

Observation: The final repair regulations add three clarifying examples that demonstrate the application of this rule. The taxpayers in Example 6 (grocery changes property to offer sushi bar) and Example 7 (hospital changes property to offer outpatient surgery center) do not adapt the property to a new or different use. In contrast, the taxpayer in Example 5 (drug store changes property to offer walk-in medical clinic) adapts the property to a new or different use.

Indirect costs

The final repair regulations provide that a taxpayer must capitalize the direct costs of an improvement of an asset and all indirect costs, including otherwise deductible repair and removal costs that directly benefit or are incurred by reason of an improvement. On the other hand, costs arising from activities that do not directly benefit, and that are not incurred by reason of, an improvement to the assets are not required to be capitalized under Section 263(a), regardless of whether the activities are performed at the same time as an improvement that must be capitalized. The final repair regulations add the application of this standard to the analysis in several examples. See, e.g., Example 24.

The final repair regulations add an exception to this rule that allows individuals to capitalize amounts paid for repair and maintenance that are made at the same time as an improvement to the taxpayer's residence.

Observation: Although the final repair regulations no longer contain a cross-reference to the indirect cost standard in Section 263A, the preamble states that the final repair regulations adopt a standard for indirect cost capitalization based on Section 263A language. The preamble also confirms that this standard obsoletes the plan of rehabilitation doctrine "to the extent that the court created doctrine provides different standards."

Simplifying conventions and safe harbors

Safe harbor for small taxpayers

The final repair regulations provide a safe harbor for taxpayers with gross receipts of $10 million or less. These "qualifying small taxpayers" can elect to not apply the improvement rules to an eligible building property if the amount paid during the tax year for repairs, maintenance, and improvements on the building is less than the lesser of $10,000 or 2 percent of the unadjusted basis of the building. Eligible building property generally includes buildings and leased buildings with an unadjusted basis of $1 million or less. For purposes of qualifying for the safe harbor, amounts paid for repairs, maintenance, and improvements include amounts that have been deducted under the de minimis rule and routine maintenance safe harbor for buildings (discussed below).

Election to capitalize repair and maintenance costs

The final repair regulations include an annual election to treat amounts paid during the tax year for repair and maintenance to tangible property as amounts paid to improve that property. If a taxpayer incurs costs in a trade or business and if the taxpayer treats these amounts as capital expenditures on its books and records used in computing income, these costs may be capitalized and depreciated for tax purposes. A taxpayer making this election for a tax year must apply this method to all amounts paid for repair and maintenance of tangible property treated as capital expenditures on its books and records during that tax year.

A taxpayer makes an election to capitalize repairs and maintenance costs by attaching a statement to the taxpayer's timely filed original federal tax return (including extensions) for the tax year in which the taxpayer paid such amounts. An election may not be made through the filing of an application for change in accounting method. If an election has been made, the taxpayer must begin to depreciate the cost of capitalized improvements when the amounts are placed in service by the taxpayer. The election does not apply to rotable or temporary spare parts to which the taxpayer applies the optional method of accounting.

Observation: This election is a welcome simplification for taxpayers that overcapitalize repair costs and were concerned about the burden of compliance with the new regulations. However, the election to capitalize repair and maintenance costs does not release the taxpayer from the obligation to capitalize for tax purposes amounts required to be capitalized under the final repair regulations that have been expensed on the taxpayer's books and records. As a result, taxpayers still will need to analyze the final repair regulations vis-à-vis their book capitalization methods to ensure compliance with the final repair regulations.

Routine maintenance safe harbor

The routine maintenance safe harbor provided in the 2011 temporary regulations is retained in the final repair regulations, but 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 for 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 by the taxpayer, 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 by the taxpayer.

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 by the taxpayer, 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, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statements.

Significantly, 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.

Observation: The 2011 temporary regulations did not include costs incurred for buildings in the routine maintenance safe harbor. Upon request from commentators, the IRS and Treasury revised the rule to apply to routine maintenance for buildings. However, the expansion to buildings may be useful in a fairly limited number of circumstances. The examples offered in the regulations are related to scheduled maintenance on elevators or HVAC systems, expenditures that many taxpayers already expense.

Observation: As a result of the increase in list of ineligible costs, particularly to exclude betterments, the routine maintenance safe harbor may have limited applicability.

Regulatory accounting method

The final repair regulations retain the rules under the 2011 temporary regulations that allow taxpayers that are subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface Transportation Board (STB) to follow the methods of accounting used for regulatory accounting purposes in determining whether amounts improve property under Section 263(a). However, the final repair regulations modify the description of the regulatory accounting method to clarify that, for purposes of determining whether an amount must be capitalized for income tax purposes, an eligible taxpayer must apply the method of accounting that it is required to follow by FERC, FCC, or STB, whichever is applicable.

Observation: A taxpayer using the regulatory accounting method must use it for all its tangible property subject to regulatory accounting rules. The method does not apply to property for the tax years in which the taxpayer elected to apply the repair allowance under Reg. sec. 1.167(a)-11(d)(2).

The takeaway

The final repair regulations generally retain many of the rules for UOP and acquisition or improvement of property. Certain rules — such as the definition of a building — were changed or modified to provide taxpayers with clarity for purposes of applying the rules to their facts and circumstances. The final repair regulations provide a new casualty loss rule that requires taxpayers to capitalize restoration amounts only to the extent of the adjusted basis claimed as a casualty loss and to claim a deduction for the excess amount paid for restoration of damage to a UOP, which eliminates the need to elect to forgo a casualty loss (through the use of GAAs) in order to claim a deduction for repairs.

The final repair regulations also provide safe harbors for taxpayers that may simplify the application of the rules. In particular, the final repair regulations provide a safe harbor for small taxpayers (taxpayers with gross receipts of $10 million or less) for applying the improvement rules to an eligible building property. The final repair regulations also provide a new election that allows taxpayers to conform to their books and records regarding the capitalization of amounts paid for repair and maintenance costs. If this election is made, all amounts paid for repair and maintenance costs of tangible property and treated as capital expenditures for book purposes must be treated the same for tax purposes. The routine maintenance safe harbor provided in the 2011 temporary regulations was modified significantly to include buildings and to increase the list of ineligible costs.

In addition, the final repair regulations provide numerous examples that illustrate the application of the rules. These examples should assist taxpayers in understanding and implementing the final regulations.

On October 9, 2013, PwC hosted an in-depth webcast to analyze the impact of the final repair regulations and proposed disposition regulations.

A link to the archived replay can be found here: http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=688567&sessionid=1&key=10B22BFDF14B36E66B2BE404853A4A31

Let's talk

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