

WNTS Insight



Forthcoming tangible property regulations expected to address several key issues

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In 2008 the IRS issued repropounded regulations under section 263(a) for amounts paid to acquire, produce, or improve tangible property (the "2008 repropounded regulations"). These regulations first had been issued as proposed regulations in August 2006 (the "2006 proposed regulations"). The 2006 proposed regulations contained many provisions that were criticized as complex, not providing certainty, or otherwise overly burdensome to taxpayers.

Since the issuance of the 2008 repropounded regulations, there has been significant IRS activity related to the tax treatment of repairs, including designating repairs as a Tier I issue (see WNTS Insight, "[LMSB designates 'repairs vs. capitalization' as a Tier I issue](#)," January 26, 2010); issuing an audit technique guide (see WNTS Insight, "[New IRS audit technique guide provides helpful insights on tax treatment of repairs costs](#)," December 17, 2010); and including a repairs change in accounting method in the mass automatic change in accounting method Revenue Procedure (see sections 3.06, 6.24, and 6.25 of the Appendix of Rev. Proc. 2011-14). For additional discussion, see WNTS Insight, "[Tax treatment of repairs and maintenance of tangible assets may present opportunity for many taxpayers](#)," November 18, 2009.

The IRS has received numerous comments and recommendations related to the 2008 repropounded regulations under section 263(a) to improve, clarify, and simplify the rules. The IRS announced recently that the forthcoming regulations anticipated to be issued in the spring of 2011 will be a combination of proposed, temporary, and final rules. Key issues expected to be addressed are discussed below.

Potential issues in the repairs regulations

Unit of property

A threshold issue that must be addressed before a taxpayer can determine whether a unit of property (UOP) has been improved is identification of the UOP itself. The 2008 repropounded regulations provide a simplified scheme, compared to the 2006 proposed regulations, for

determining the appropriate UOP. However, some commentators have criticized the guidelines provided in the 2008 repropounded regulations. Further, the 2008 repropounded regulations do not provide UOP rules for network assets.

Because UOP identification is a fact-based analysis, determination of an appropriate UOP has been a contentious issue on exam. The future section 263(a) regulations or other industry-specific guidance (such as an Industry Issue Resolution (IIR)) should provide guidance on what the IRS believes to be the appropriate factors to be used to determine the appropriate UOP. **Observation:** Indications are that the regulations will identify functional interdependence as a significant, perhaps controlling, factor in deciding the UOP for tangible personal property. Functional interdependence already is the controlling factor for purposes of Reg. sec. 1.263A-10 on UOP; the concept also played a prominent role in cases such as *Ingram Industries v. Commissioner*, T.C. Memo. 2000-323, *FedEx v. U.S.*, 291 F. Supp.2d 699 (2003), *aff'd* 412 F.3d 617 (6th Cir. 2005), and *Smith Vanalco v. Commissioner*, 300 F.3d 1023 (9th Cir. 2002), *affirming* T.C. Memo. 1999-265.

Currently, the IRS has IIR projects underway to address UOP issues for the telecom industry and the electric utility industry, relating to generation assets as well as transmission and distribution assets. These IIR projects are anticipated to be published in the coming months. The IRS has stated that the next IIR project to address UOP issues will be for natural gas utilities; guidance is anticipated to be published sometime this year.

Another significant UOP issue relates to major components or systems of a building. As noted in a recent comment letter submitted by the AICPA, there has been significant examination activity related to whether a building's HVAC system or other structural components are treated as separate UOPs from the underlying building for purposes of repair and disposition tax rules. Preliminary indications from IRS officials suggest that for repair purposes, a major component of a building could be treated as a separate UOP, while for disposition purposes the component would be included in the building UOP. Under this standard, replacement of an entire HVAC system would result in the replacement

of a UOP and thus an expenditure that must be capitalized, while disposition of the HVAC system would be a nondeductible partial disposition of the building. This issue may be addressed in the forthcoming regulations.

Betterments

The statute and the regulations under section 263(a) require capitalization of amounts that result in a betterment of an asset. Promulgating a set of objective and easily administrable rules to identify when an expenditure is a betterment is difficult. The 2008 repropounded regulations would identify an expenditure as a betterment if it (1) ameliorates a material condition or defect that existed prior to the acquisition of the property or arose during the production of the UOP, (2) results in a material addition to the UOP (physical enlargement, expansion, or extension), or (3) results in a material increase in capacity, productivity, efficiency, strength, or quality of the UOP or its output.

Observation: The rules to determine whether an expenditure results in a betterment likely will be further modified or clarified in the forthcoming regulations.

De minimis rule

The 2008 repropounded regulations would provide a de minimis rule under which expenditures below certain amounts to acquire or produce tangible property need not be capitalized. This de minimis rule would be available for a taxpayer that meets the following tests:

- The taxpayer has an applicable financial statement;
- As of the beginning of the tax year, the taxpayer has written accounting procedures treating as an expense for nontax purposes property costing less than a certain dollar amount;
- The taxpayer deducts the amounts on the applicable financial statement in accordance with the written procedures; and
- The total amount paid to acquire or produce tangible property and not capitalized does not distort taxable income.

Although the 2008 repropounded regulations do not include a definition of

when an amount paid would be deemed to distort taxable income, those regulations include a safe harbor -- based on either the taxpayer's gross receipts or total depreciation and amortization expenses -- that, if satisfied, would deem an amount to not distort taxable income.

Observation: The proposed safe harbor may be of limited use to taxpayers because of the safe harbor's low limits.

The preamble to the 2008 repropounded regulations states that the proposed regulations are not intended to change a de minimis rule or capitalization threshold a taxpayer has negotiated and agreed to with its examining agent. **Observation:** At this time, we expect that a de minimis rule in some form will be included in the forthcoming regulations.

Plan of rehabilitation

The 2008 repropounded regulations would require taxpayers to capitalize repairs and maintenance performed at the same time that an improvement is made when such costs are incurred to make the improvement. The regulations would not require capitalization of repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement even if they are performed at the same time. For example, repainting typically would be viewed as a deductible repair. However, repainting that occurs during an overall remodel would be capitalized under the judicially created "plan of rehabilitation" concept. Under the 2008 repropounded regulations, repainting that occurs at the same time as a remodel, but not in the area that was remodelled, would not have to be capitalized.

Observations: The 2008 repropounded regulations do not incorporate the judicially created plan of rehabilitation doctrine. The preamble to the 2008 repropounded regulations states that, when the regulations are finalized, the plan of rehabilitation doctrine will be obsolete and that the uniform capitalization rules in section 263A will be applicable for purposes of determining whether a cost incurred as part of an overall plan to rehabilitate property must be capitalized. The preamble indicates that any costs incurred as part of the overall plan of rehabilitation that do not directly benefit or are not incurred by reason of the plan are not

required to be capitalized. Under this approach, any routine maintenance performed at the same time that does not directly benefit or is not incurred by reason of the plan would not have to be capitalized. Informal comments from government officials made after the issuance of the 2008 repropounded regulations suggested that the government does not necessarily view the plan of rehabilitation doctrine as obsolete, but as subsumed by the uniform capitalization rules of section 263A, and that the forthcoming regulations will clarify the government's views on how the two sets of rules interrelate and are applied.

Repair allowance

The 2008 repropounded regulations do not include a repair allowance. The preamble indicates that while commentators generally favored including a repair allowance, both commentators and the government believe that a "one-size-fits-all" repair allowance would not be appropriate. The IRS proposes to issue industry-specific repair allowance guidance by publication in the Internal Revenue Bulletin. Following the issuance of the 2008 repropounded regulations, IRS officials encouraged industries to participate in the IIR process to develop industry-specific repair allowance guidance.

Effective date and implementation

It is anticipated that the temporary and final portions of the forthcoming regulations will be effective prospectively for expenditures made in tax years beginning after the publication date of the regulations. As was the case with the final intangibles regulations under Reg. secs. 1.263(a)-4 and 1.263(a)-5, it is anticipated that any changes in method of accounting that taxpayers must make to adopt the rules provided in the repairs regulations will be implemented using the automatic method change procedures. There currently is no indication from the IRS regarding whether these method changes will be implemented using a full section 481(a) adjustment, a modified cut-off (i.e., a limited section 481(a) adjustment), a full cut-off (i.e., no section 481(a) adjustment), or some combination of the foregoing. However, if the final regulations are made effective on a prospective basis, then current case law would continue to be applicable to tax years prior to the effective date.

Conclusion

Taxpayers and tax professionals hope that release of the tangible regulations, which are expected to consist of final, temporary, and proposed rules, will address the outstanding concerns and issues discussed above. However, it is not anticipated that the final regulations will clarify retroactively whether costs are currently deductible or capitalizable for tax years before the effective date of the regulations.

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