WNTS Insight

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The tangible property repair regulations: Plan of rehabilitation, environmental remediation, rotable spare parts, general asset accounts, removal costs, and recovery of certain capital improvements

This is the third WNTS Insight in a three-part series that discusses in depth the recently issued temporary and proposed regulations regarding the deduction and capitalization of expenditures related to tangible property (the temporary regulations or repair regulations).

The first Insight discussed rules related to effective dates, units of property, and dispositions. (See WNTS Insight, "The tangible property repair regulations: effective dates, units of property, and dispositions," January 4, 2012.) The second discussed rules related to the acquisition or improvement of property. (See WNTS Insight, "The tangible property repair regulations: acquisition or improvement of property," January 5, 2012.) This Insight discusses plan of rehabilitation, environmental remediation, rotable spare parts, general asset accounts, removal costs, and recovery of capital improvements subject to lease.

Plan of Rehabilitation

The temporary regulations (like the 2008 proposed regulations) provide that repairs and maintenance costs that do not directly benefit, and that are not incurred by reason of, an improvement are not required to be capitalized under section 263(a), regardless of whether the repairs and maintenance are performed at the same time as an improvement. However, the temporary regulations clarify that all indirect costs, including repair and removal costs, are subject to the rules under section 263A and therefore must be capitalized if they directly benefit or are incurred by reason of an improvement.

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The temporary regulations retain an exception to the general rule that certain repair and maintenance costs paid or incurred by individuals need not be capitalized even if they are incurred at the same time as an improvement. Thus, under this exception, individuals may capitalize amounts paid for repairs and maintenance that are made at the same time as capital improvements to a unit of property (UOP) not used in the individual's trade or business or for the production of income if such amounts are paid to remodel the taxpayer's residence.

Observation: While the preamble to the 2008 proposed regulations stated that section 263A eliminated the need for a plan of rehabilitation doctrine, the preamble to the temporary regulations states only that the adoption of the Reg. sec. 1.263A-1(e) standard for purposes of section 263(a) obsoletes the plan of rehabilitation doctrine "to the extent the court created doctrine provided different standards for determining whether an otherwise deductible indirect cost must be capitalized as part of an improvement."

Environmental Cleanup of Reacquired Property

Referencing the 2008 proposed regulations, the preamble to the temporary regulations explains that environmental cleanup costs associated with reacquired property generally are considered to result in a betterment, and thus a capitalizable improvement, to the extent they are incurred to ameliorate a material, pre-existing condition or defect. Accordingly, a taxpayer generally must capitalize environmental cleanup costs if the taxpayer contaminated property in the course of its business operations, disposed of the property, and later reacquired the property to clean-up the contamination.

Observation: While acknowledging that there may be instances in which capitalization of environmental cleanup costs is not appropriate, the IRS was reluctant to outline any exceptions in the temporary regulations. Instead, the IRS encourages taxpayers with unusual facts and circumstances to request a private letter ruling.

Rotable Spare Parts

Rotable and temporary spare parts are included as materials and supplies under Temp. Reg. sec. 1.162-3T. The regulations provide a taxpayer with three methods for treating costs related to rotable spare parts; the taxpayer must use the elected method for all rotable and temporary spare parts in the same trade or business. Two of the methods are consistent with the 2008 proposed regulations, which allow a taxpayer to deduct the cost of the rotable or temporary spare parts when used or consumed, or to elect to capitalize and depreciate the cost of such parts over the applicable recovery period.

The third method, known as the optional method for rotable parts, permits a taxpayer to:

- Deduct the cost to produce or acquire the part upon initial installation,
- Recognize in gross income the fair market value (FMV) of the part when removed from the UOP, and include the FMV and cost to remove the part in the basis of the part,
- Add to the basis of the part any amount paid to repair, maintain, or improve the part,

- Deduct the cost of reinstallation and basis not previously deducted in the tax year in which the part is reinstalled, and
- Deduct any remaining amount of basis in the part in the tax year in which it is disposed of.

Temp. Reg. sec. 1.162-3T treats as materials and supplies some tangible property that had been treated as depreciable property under previously published guidance. Although taxpayers generally may elect to treat rotable spare parts as depreciable property, the temporary regulations modify some revenue rulings, including Rev. Ruls. 2003-37, 81-185, 69-200, and 69-201, to the extent the rotable spare parts are now considered materials and supplies. The IRS has requested comments regarding modifications that may need to be made to Rev. Proc. 2007-48 (safe harbor method of accounting to treat certain rotable spare parts as depreciable assets) for the treatment of certain rotable spare parts now defined as materials and supplies.

Observation: Rotable spare parts that are not considered materials and supplies must be capitalized in accordance with Temp. Reg. secs. 1.263(a)-2T and -3T, as applicable. Property will not be considered a material or supply if it is acquired or produced as part of a single piece of property.

General Asset Accounts

Temp. Reg. sec. 1.168(i)-1T makes a variety of changes to the existing rules under section 168(i)(4) for general asset accounts. The temporary regulations expand the assets that may be included in each general asset account by eliminating the existing rule that each general asset account must include only assets that have the same asset class. Instead, each general asset account must include only assets that:

- Have the same applicable depreciation method;
- Have the same applicable recovery period;
- Have the same applicable convention; and
- Are placed in service by the taxpayer in the same taxable year.

The temporary regulations do not change the existing special rules for establishing general asset accounts, but add new rules to be consistent with the temporary regulations for establishing multiple asset accounts for modified accelerated cost recovery system property depreciable under section 168.

In addition, because the rules for determining the depreciation for each general asset account did not reflect the additional first-year "bonus" depreciation provisions added to section 168 since the promulgation of Reg. sec. 1.168(i)-1 in 1994, the temporary regulations provide rules for determining the depreciation for a general asset account if all the assets in the account are eligible for bonus depreciation and if all the assets in the account are not eligible for that deduction.

Removal Costs

The 2008 proposed regulations did not address the treatment of removal costs. However, examples in the 2008 proposed regulations suggested that costs to remove a component in order to facilitate a replacement that is itself an improvement to the UOP must be treated as part of the improvement.

The preamble to the temporary regulations clarifies that the costs of removing a component of a UOP must be treated as any other indirect cost incurred during the

improvement of property. Thus, under the temporary regulations, the costs of removing a component of a UOP must be capitalized if they directly benefit or are incurred by reason of an improvement to a UOP (i.e., treatment similar to otherwise deductible repair and maintenance costs incurred during an improvement). In contrast, the costs of removing a component may be deducted if such costs relate only to the disposition of the removed property and do not directly benefit and are not incurred by reason of an improvement. Finally, the temporary regulations do not affect the current-law rule that the costs of removing an entire UOP may be currently deductible (*see* Rev. Rul. 2000-7).

Observation: The preamble to the repair regulations indicates that a taxpayer must determine whether the removal of a component directly benefits, or is incurred by reason of, an improvement. This is in contrast with Rev. Rul. 2000-7, in which the IRS indicated that the cost of removing a complete UOP generally is allocated to the removed asset and an analysis under section 263(a) generally is not required.

The temporary regulations address moving and reinstallation costs in certain examples under Temp. Reg. sec. 1.263(a)-3T(h)(4) (see Examples 9 and 10). These examples illustrate that amounts paid to move and reinstall a UOP that has already been placed in service by the taxpayer generally are not amounts paid to acquire or produce a UOP and therefore do not have to be capitalized under the rules for the acquisition or production of property. However, if the costs of moving and reinstalling a UOP directly benefit, or are incurred by reason of, an improvement to the UOP that is moved and reinstalled, then such costs must be capitalized.

Rentals and Leased Property

The temporary regulations modify existing regulations under sections 162 and 167 related to the period over which the cost of improvements to leased property is recovered. Temp. Reg. sec.1.162-11(b) provides that the cost incurred by a lessee to erect buildings or make permanent improvements on leased property is a capital expenditure and is not deductible as a business expense. Temp. Reg. sec. 1.167(a)-4T provides that capital expenditures made by either a lessee or lessor to leased property are recovered under the applicable provisions of the Internal Revenue Code (for example, sections 167, 168, or 197), without regard to the term of the lease.

Observation: In general, these changes to Reg. secs. 1.162-11 and sec. 1.167(a)-4 conform these regulations to changes made to the Internal Revenue Code in 1986. Since 1986, these costs have been recoverable under the applicable cost recovery provisions of the Code without regard to the length of the lease. Likewise, the changes to these regulations do not change the manner in which costs to acquire a leasehold interest are recovered. Accordingly, such costs continue to be recovered ratably over the applicable term of the lease.

Link to registration information for January 19 PwC Webcast on the repair regulations:
http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=393301&sessionid=1&key=5F824A9363C2819ABC45DCC72485E6EA

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