

WNTS Insight

A Washington National Tax Services (WNTS)
Publication

December 27, 2011

Proposed/temporary tangible capitalization regulations: high-level overview

This WNTS Insight will provide a high-level overview of the recent proposed and temporary regulations (REG - 168745-03, the temporary regulations) issued on Friday, December 23, under section 263(a), Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property. (See WNTS Insight, "[IRS releases long-awaited tangible property repair regulations](#)," December 23, 2011.)

Although the temporary regulations adopt many of the principles in the 2008 proposed regulations (the proposed regulations), the temporary regulations create new rules that are significantly different relative to prior law and the proposed regulations.

The temporary regulations generally are effective for tax years beginning on or after January 1, 2012, and generally require a section 481(a) adjustment when a taxpayer makes an accounting method change to comply with the temporary regulations.

High-Level Overview

"De minimis" or "minimum capital" rule

The temporary regulations continue to provide the de minimis rules established by the proposed regulations, with two main exceptions. First, for acquired property, the temporary regulations continue to include a de minimis rule under which a taxpayer may expense the cost of acquired property that does not exceed a certain dollar threshold. However, the regulations provide a revised "ceiling" threshold that the aggregate of such amounts paid cannot exceed. Further, the temporary regulations do not permit a taxpayer without a financial statement to avail itself of the de minimis rule.



Second, in a welcome administrative-relief change from the proposed regulations, amounts paid for materials and supplies are subject to the de minimis rule only if the taxpayer elects to treat them as such.

Unit of property (UOP)

The temporary regulations significantly modify the UOP rules with respect to a building and its structural components. Specifically, the temporary regulations provide separate UOP rules for buildings (including structural components thereof) and major building systems (e.g., a HVAC system, an electrical system, and a security system) when the building and the major building systems are treated as separate UOPs. Additional UOP rules are provided for plant property (based on a major and discrete function), machinery and equipment (generally based on a functional interdependence test), and leasehold improvements. The temporary regulations provide that the same UOP is used for repair and retirement purposes. In addition, the temporary regulations require a taxpayer that replaces a major building system to capitalize the cost of the replacement system, but allows the taxpayer to deduct the remaining basis of the system that is disposed of.

The leasehold improvement rules are new to the temporary regulations and address many questions left unanswered by the proposed regulations. In general, the temporary regulations provide that in the case of a taxpayer that is a lessee of all or a portion of a building, the UOP is each building and its structural components or the portion of each building and structural components subject to the lease. The temporary regulations provide several examples to illustrate these new rules.

Removal costs

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. However, the temporary regulations maintain the prior-law rule that the costs of removing an entire UOP may be currently deductible.

Appropriate Comparison

When a particular event necessitates an expenditure, a taxpayer must compare the condition of the UOP immediately following the expenditure to the condition of the property immediately prior to the circumstances that necessitated the expenditure.

For normal wear and tear (including pre-existing defects), the appropriate comparison is to the condition after the last correction of normal wear and tear. In the case of a taxpayer that has not previously corrected the effects of normal wear and tear, the appropriate comparison is to the condition of the property when such property was placed in service.

Betterments

The temporary regulations retain the criteria necessary to determine whether an amount paid results in a betterment, and thus in a capitalizable improvement. Specifically, an amount paid will result in a capitalizable betterment if such amount ameliorates a material condition or defect, results in a material addition to the UOP, or results in a material increase in capacity, productivity, efficiency, strength, or quality of the UOP. A betterment is determined based on facts and circumstances. Replacements with comparable parts do not necessarily result in capitalization.

Substantial increase in life

The temporary regulations maintain the capitalization requirement for amounts paid for the replacement of a part or combination of parts that comprise a major component or a substantial structural part of a UOP. However, the temporary regulations replace the 50-percent threshold standards in the proposed regulations with a facts-and-circumstances approach as used by the courts, including the quantitative or qualitative significance of the part or combination of parts in relation to the UOP.

Plan of rehabilitation doctrine

The temporary regulations retain the general rule from the proposed regulations 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, 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.

Routine maintenance safe harbor

In general, the temporary regulations retain the routine maintenance safe harbor from the proposed regulations. Accordingly, an amount paid for routine maintenance -- e.g., the inspection, cleaning, and testing of a UOP -- does not improve that UOP. However, buildings are excluded from the safe harbor.

Optional regulatory accounting method

A taxpayer that uses a regulatory accounting method may use such method instead of determining under the general rules of section 263(a) whether amounts paid to repair, maintain, or improve property are capital expenditures or deductible expenses. This method is available to a taxpayer that is subject to the regulatory accounting rules of the Federal Energy Regulatory Commission, the Federal Communications Commission, or the Surface Transportation Board.

Casualty Loss

Despite comments requesting the removal of the casualty loss rule, the temporary regulations retain this rule. The casualty loss rule provides that an amount paid to restore a UOP is a capital expenditure if it is for the repair of damage to the UOP for which the taxpayer had properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165.

By retaining the casualty loss rule, however, the temporary regulations do not limit a taxpayer's ability to accelerate the recovery of the basis through the section 165 loss provisions. Rather, the temporary regulations require a taxpayer to capitalize the costs of restoring the property, with recovery of such costs permitted through depreciation over the proper recovery period. The temporary regulations, however, do include an election allowing a taxpayer to forgo the casualty deduction and deduct the cost of the repair.

General Asset Accounts

The temporary regulations make a variety of changes to the existing rules under section 168(i)(4) for general asset accounts, consistent with the temporary regulations for MACRS property.

Transition Rules

The temporary regulations generally are effective for tax years beginning on or after January 1, 2012, or, when applicable, to amounts paid or incurred to produce or acquire property in a tax year beginning on or after January 1, 2012. The temporary regulations generally expire on December 23, 2014.

In general, a change to comply with the temporary regulations is a change in method of accounting made with an adjustment under section 481(a). A change to the de minimis rule, however, is implemented on a cut-off basis.

Two related revenue procedures that we expect to be issued in the near future are expected to provide automatic procedures necessary for taxpayers to change their method of accounting to conform to the temporary regulations.

Upcoming PwC Technical Guidance on the Temporary Regulations

WNTS Insight

Next week, PwC's National Tax Services office will issue a more robust WNTS Insight that will take a deeper dive into the temporary regulations and provide more in-depth insight and analysis. This document will provide taxpayers with additional insights regarding the impact the temporary regulations could have on their businesses.

PwC Webcast

On January 19, 2012, from 12pm to 1:30 pm EST, PwC will host a webcast on the temporary regulations featuring a panel of PwC specialists who will review and analyze the temporary regulations in depth, and discuss what action, if any, taxpayers should consider taking as a result of the new rules. Webcast details and registration information will be forthcoming.

For more information, please do not hesitate to contact:

PwC Tax Projects Delivery Group Contacts

Robert Love (414) 212-1723 robert.d.love@us.pwc.com

Devin Hall (713) 356-5212 devin.c.hall@us.pwc.com

PwC National Tax Services Contacts

George Manousos (202) 414-4317 george.manousos@us.pwc.com

David Crawford (202) 414-1039 david.l.crawford@us.pwc.com

James Liechty (202) 414-1694 james.f.liechty@us.pwc.com

Link to WNTS Insight archive: <http://www.pwc.com/us/en/washington-national-tax/newsletters/washington-national-tax-services-insight-archives.jhtml>

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

SOLICITATION

© 2011 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.