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MEMORANDUM

To:

From: Gary Guenther
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7-7742

Subject: **Final Regulations on the Tax Treatment of Expenditures for the Acquisition, Repair, Maintenance, and Improvement of Tangible Property**

In response to your request, this memorandum discusses the key elements of the final repair regulations (T.D. 9636) that the Internal Revenue Service (IRS) issued on September 19, 2013.[1] Release of the regulations marked the completion of a nine-year journey that began in 2004 when the IRS published a notice of intent for proposed rule-making on the capitalization of expenses related to tangible property under Section 263(a). There were several significant developments along the way. The IRS issued proposed regulations on the tax treatment of those expenses in August 2006, revised those regulations in March 2008, and issued temporary regulations in December 2011. Let me know if you have any questions.

To varying degrees, all businesses use materials and supplies and incur expenses for the acquisition, production, repair, maintenance, or improvement of tangible depreciable property. One significant challenge they face in accounting for those expenses for tax purposes lies in having a clear understanding of the rules for determining when the expenses can be deducted as an ordinary and necessary business expense and when they must be capitalized and depreciated.

Historically, a central issue for many businesses was a lack of clarity and certainty about the distinction between deductible expenditures for repairs and maintenance and depreciable expenditures for improvements to such property. Disagreements between the IRS and taxpayers over whether an expenditure on tangible property could be deducted or had to be capitalized were typically resolved through appeals to case law (including several Supreme Court rulings) and a careful consideration of the facts and circumstances surrounding the disputed claims.[2] The main drawback to this approach to resolving differences was that it tends to be time-consuming and costly for the parties involved.

The final repair regulations seek to clarify the rules for determining when expenditures for the acquisition, production, repair, maintenance, and improvement of real and personal tangible property (e.g., machine

[1] The IRS released a set of proposed rules (REG-110732-13) for the disposition of tangible property along with the final repair regulations. These rules are not examined here, as they do not directly concern the issues addressed by T.D. 9636.

[2] Christian Wood, "Implementing the New Tangible Property Regulations," *Journal of Accountancy*, Feb. 2014, p. 23.

tools, computer systems, heating and cooling equipment, and buildings) can be deducted as a current expense under Section 162(a) of the federal tax code, and when they must be capitalized and recovered through depreciation allowances under Section 263(a). Section 162(a) allows companies to deduct all the ordinary and necessary expenses they incur in earning an income, including the costs of materials and supplies, maintenance, and repairs for tangible property. Section 263(a), by contrast, requires companies to capitalize and depreciate the amounts they pay or incur to acquire, produce, or improve tangible property.

Like the 2011 temporary regulations, T.D. 9636 establishes a general framework for distinguishing depreciable capital costs like the acquisition or improvement of tangible property from deductible business expenses like the purchase of materials and supplies and repairs and maintenance. The framework integrates the basic rules and concepts that have been developed over the years through court cases and IRS guidance. A critical consideration is whether an expense is intended to keep a unit of tangible property in normal operating condition or to produce future income in the same manner as a new investment would. Clear-cut (or "bright-line") tests are notably absent from the final regulations. Consequently, facts and circumstances are likely to continue to play a critical role in determining whether an expense related to tangible property should be capitalized or may be deducted in full in the tax year when it is incurred or paid.[3]

While the final regulations retain many of the rules from the 2011 temporary regulations, they also refine and simplify some of them. One notable difference between the two sets of regulations is that T.D. 9636 creates several new safe harbors for the current deduction of costs that otherwise would have to be capitalized. The final regulations apply to tax years beginning on or after January 1, 2014, though taxpayers have the option of applying them to any tax year beginning on or after January 1, 2012

The final regulations address the following issues, each of which is discussed below:

- Change in accounting methods
- Materials and supplies:
    - De minimis rule
    - Spare parts
- Unit of property
- Acquisition or production of new property
- Improvements to tangible property
    - Safe harbor for building improvements
- Routine maintenance safe harbor
- Option to capitalize repair and maintenance costs

[3] CCH Special Report: *Comprehensive Analysis of Final Repair/Capitalization and Proposed MACRS Disposition Regulations*, Feb. 17, 2014, p. 12, available at http://tax.cchgroup.com/downloads/files/pdfs/legislation/repair-regs_special-report.pdf.

General Rule

Before the final regulations went into effect, the general rule for determining whether an expense related to tangible property was currently deductible or depreciable hinged on the purpose of the expense. If the expense was intended to restore such property to its normal operating condition, then it could be deducted as a current expense. But if the expense was intended to replace, modify, improve, or expand the property in ways that prolonged its useful life, increased its market value, or modified the property for uses other than its original ones, then the expense had to be capitalized and recovered through the depreciation allowances permitted under federal tax law.

The new Section 263(a) regulations retain this general rule—but with a few notable differences. In the view of some tax practitioners, the final regulations add more certainty to the process of determining whether an expense is deductible or depreciable. In crafting the regulations, the IRS was seeking to switch from an approach based on facts and circumstances and subjective judgments to one grounded in case law and an abundance of examples and so-called bright-line rules.[4]

Change in Accounting Methods

The final regulations require taxpayers to evaluate their methods of accounting to determine whether they conform to the new rules. Any adjustments to those methods would be made under Section 481(a) of the federal tax code. Such an adjustment could involve considerable work for some taxpayers, as it requires taxpayers that incurred expenses to repair or improve tangible property during the two years before January 1, 2014 to review their tax treatment of those expenditures to determine whether they conform to the new rules. If the treatment was more favorable than the rules allow, a taxpayer will have to return some of the benefit through filing an amended return, but if the treatment was less favorable, the taxpayer should be able to claim missed repair deductions for the relevant tax years.

Materials and Supplies

One of the essential elements of the final regulations is the tax treatment of amounts paid for materials and supplies. Before the regulations were issued, there was considerable uncertainty among taxpayers about the definition of materials and supplies under the federal tax code. The final regulations attempt to clarify the definition. Specifically, materials and supplies are considered tangible property that is used or consumed in a taxpayer's operations and that is not part of inventory and has one of the following attributes:

- a component to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer that is not part of any single unit of tangible property;
- fuel, lubricants, water, and similar items that are expected to be consumed within 12 months of initial use;
- a unit of property with a useful life of 12 months or less;
- a unit of property with an acquisition or production cost of $200 or less; or

[4] W. Eugene Seago, "'Improvements' Under the Repair Regulations," *Tax Notes*, Feb. 10, 2014, p. 651.

- any other tangible property that is identified in published guidance in the Federal Register or the Internal Revenue Bulletin as materials or supplies that qualify for the treatment specified in Reg. § 1.162-3.

The final regulations attempt to clarify the circumstances under which the cost of materials and supplies may be deducted as a current expense or must be capitalized and recovered through depreciation allowances.

Generally, the cost of materials and supplies that are not used to improve tangible property or to produce such property may be deducted as a current expense. The main issue for taxpayers is the timing of the deduction. This depends on whether the materials and supplies can be regarded as incidental or non-incidental. [5] In the case of non-incidental materials and supplies, the cost may be deducted in the year when they are consumed or used. But in the case of incidental materials and supplies, the cost should be deducted in the year when they are purchased, provided no usage or inventory records are kept and the treatment clearly reflects taxable income.[6]

There are two sets of circumstances that require taxpayers to capitalize the cost of materials and supplies under the final regulations. First, materials and supplies used to produce tangible property are subject to the uniform capitalization rules under Section 263A. This means that the amounts paid for materials and supplies used in the production of inventory or self-assembled assets have to be capitalized and depreciated. The same treatment applies to the amounts paid to produce the materials and supplies that are used in the production of those materials and supplies.

Second, the amounts paid for materials and supplies used to improve tangible property must be capitalized and depreciated as part of the cost of the improvement.

The final regulations also set forth special rules for the tax treatment of the amounts paid for spare parts, which are treated as materials and supplies for tax purposes, and create a *de minimis* safe harbor for materials and supplies.

Spare Parts

The final regulations give taxpayers several options for accounting for the amounts they pay to acquire spare parts.

One option is that taxpayers may deduct those amounts in the year the parts are used or consumed in the case of "rotable, temporary, and emergency standby spare parts.[7]" Rotable and temporary spare parts are considered used or consumed in the year when they are discarded; emergency standby spare parts are considered used or consumed in the year when they are installed.

Taxpayers also have the option of deducting the cost of temporary or rotable spare parts in the year when the part is first installed, instead of the year when it is disposed of. This method does not apply to emergency standby parts, but it does require complex recordkeeping. Under the optional method, a taxpayer deducts the cost of an eligible part in the year when it is installed. When the part is removed, the taxpayer then includes the fair market value of the part in his gross

[5] Non-incidental materials and supplies are items for which consumption or inventory records are maintained; they can include spare parts and inventory items for small firms.

[6] Incidental materials and supplies are items for which no consumption or inventory records are kept.

[7] A rotable spare part is a component that is installed on a unit of property owned, leased, or serviced by the taxpayer and later removed from the property, repaired or improved, and then either reinstalled on the same property or stored for later installation. Temporary spare parts are components that are used until a new or repaired component can be installed; the temporary parts are removed and stored for later use.

income and increases his basis in the part by that value plus the cost of removing the part and any amount paid to repair, maintain, or improve it. When the part is re-installed, the taxpayer deducts his basis along with the reinstallation costs from gross income. The benefit from this method is that it allows taxpayers to take a deduction for the cost of eligible parts sooner rather than later.

The final regulations also allow taxpayers to capitalize and depreciate the cost of both standby emergency parts and temporary and rotable spare parts for which the optional method is not elected. But there are some limits on the scope of the option to capitalize. Specifically, this option is not available for spare parts that will be used as a component of a material or supply that is a unit of tangible property costing less than $200, or a component of a unit of such property with a useful life of less than one year.

For some taxpayers, the option to capitalize the cost of such parts can lead to significant tax savings. A case in point concerns companies with expiring credits or net operating losses carried forward from previous tax years. Companies in such a position may prefer to recover the cost of spare parts through depreciation deductions taken over the class lives of the parts, in lieu of deducting the full cost in the current year, in order to increase its taxable income so it can use those tax credits or net operating losses before they expire.

De Minimis Rule

The final regulations also contain a *de minimis* safe harbor that applies to the cost of acquiring or producing a unit of tangible property and the amounts paid or incurred for materials and supplies (as defined in the tax code).[8] In effect, this rule offers limited audit protection to taxpayers that take deductions for items meeting certain requirements.

Under the rule, taxpayers do not have to capitalize expenditures for eligible items whose cost is below specified amounts, and the deductions for those amounts cannot be disallowed as a result of an IRS examination. Taxpayers with an applicable financial statement[9] (AFS) may elect the safe harbor for the current tax year if they have adopted written accounting procedures at the beginning of the year that treat as a deductible expense for financial accounting purposes amounts paid or incurred for property that do not exceed $5,000 per invoice or per item or for property with a useful life of less than 12 months. By contrast, taxpayers lacking an AFS may opt for the safe harbor if the amounts they pay or incur for eligible property do not exceed $500 per invoice or item; in this case, they are not required to have written accounting procedures in place at the start of the tax year.

If a taxpayer elects the safe harbor, it applies to all materials and supplies, except for temporary and rotable spare parts subject to the optional method or those whose cost is capitalized and depreciated. In addition, if a taxpayer's non-tax accounting procedure sets the expensing limit above the $5,000 or $500 caps for the *de minimis* safe harbor, the taxpayer may be able to use those higher amounts for tax purposes, provided the taxpayer can convince IRS examiners that the amounts still reflect taxable income. It is worth pointing out that the $5,000 and $500 caps are safe harbors, not absolute limits. Still, the safe

[8] A safe harbor generally denotes a provision in law or regulations that protect an individual or other entity from liability or penalty in specified circumstances and if certain conditions have been met. Sometimes a safe harbor can reduce tax liability a taxpayer can demonstrate that he made a good-faith effort to comply with the law.

[9] An applicable financial statement is defined as a financial statement that must be filed with the Securities Exchange Commission; a certified audited financial statement accompanied by the report of an independent certified public accountant that is used to obtain credit, report to shareholders, or any achieve any other significant non-tax purpose; or a financial statement that must be provided to any state or federal government agency other than the IRS or SEC.

harbor (and the audit protection it confers) applies only to amounts paid for items whose unit cost falls below the safe harbor caps.

An example or two can clarify the practical implications of the safe harbor rule. Assume a taxpayer without an AFS elects the safe harbor and purchases 10 calculators at a cost of $300 apiece. Under the rule, the taxpayer would be allowed to deduct the total cost ($3,000) in the tax year when they are acquired, because the unit cost is below $500. But if the calculators cost $600 apiece, none of the cost could be deducted as a current expense under the safe harbor, as the unit cost would be above the $500 cap for non-AFS taxpayers. In this case, the cost would have to be capitalized and recovered through depreciation allowances.

Now assume that a company buys a steel beam to repair a unit of property it owns for $3,000, has no AFS, and adheres to a book policy of expensing items costing $500 or less. The beam is considered a material or supply for tax purposes because it is a component used to repair a unit of property. Although its cost cannot be deducted under the *de minimis* safe harbor because it exceeds the $500 cap, the beam's cost can be deducted as a material or supply in the year it is consumed or used.

Unit of Property

Another key element of the final regulations is the rules it establishes for amounts paid or incurred for the acquisition, production, or improvement of a unit of property. For real and personal property, a unit of property consists of components that are "functionally interdependent." Two components are considered functionally interdependent if one cannot be used without the presence of the other. In other words, a unit of property, under the regulations, embraces all the components needed to place the property in service. For example, an automobile is considered a unit of property for tax purposes, not its critical components; and a taxpayer cannot place in service the car's engine without also placing in service its brakes, transmission, wheels, headlights, steering, windshield wipers, and other key components.

The regulations also specify that under certain circumstances, the components of a unit of property must be treated as separate units of property for tax purposes. This happens when the component of a unit of property is treated as having a different depreciation life or method than the unit of property itself in the year the property is placed in service. For instance, taxpayers sometimes depreciate the cost of the tires of a transport vehicle, as a separate asset, over five years, rather than the three-year period that applies to the vehicle as a whole. As a result, the tires are considered a separate unit of property in the year when the vehicle is placed in service.

Each building and its structural components are considered a unit of property under the regulations. In addition, the following nine building systems are considered separate units of property:

- heating, ventilation, and air conditioning systems;
- plumbing systems;
- electrical systems;
- all escalators;
- all elevators;
- fire protection and alarm systems;
- security systems for the building and its occupants;

- gas distribution systems; and
- structural components designated as building systems in future IRS guidance.

These considerations matter because under the regulations, taxpayers are required to capitalize the amounts paid to improve units of property. Once a taxpayer identifies a unit of property from the tangible property she owns, she must apply the test for improvement specified in the regulations to determine whether expenditures on the unit of property should be capitalized as an improvement or may be deducted as a repair or maintenance.

In general, the more components a unit of property has, the greater the likelihood that amounts paid for work on the property will be considered a deductible repair. For example, if an entire building (including its major systems) is treated as a unit of property, then major work on its heating and air conditioning system could qualify as a repair under the final regulations. But if that system is treated as a separate unit of property (as the final regulations do), then the cost of that work would likely need to be capitalized.

Acquisition or Production of Tangible Property

The final regulations also clarify the expenses that must be capitalized in acquiring or producing tangible property. In general, a taxpayer must capitalize the amounts paid or incurred to acquire or produce a unit of personal or real property. Examples of such property include leasehold improvement property, land and land improvements, buildings, machinery and equipment, and office furniture. Produce in this context means to construct, build, install, manufacture, develop, create, or grow.

The amounts paid to acquire or produce tangible property pertain to the invoice price, transactions costs, and the cost of work done before the actual date the property is placed in service. This work can include repairs, installation costs, and testing expenses. For example, repairs to a building before it is placed in service must be capitalized, along with the cost of any improvements to it. Among the transaction costs that must be capitalized are any "facilitative acquisition" costs a taxpayer incurs in investigating the acquisition or production of tangible property. These costs must be added to the basis of the property. Examples of facilitative acquisition costs are shipping fees, moving expenses, appraisal fees, application fees, bidding costs, property title examinations, and fees for obtaining regulatory approval and needed permits.

Capitalized expenditures are recovered through depreciation allowances, the cost of goods sold, or by adjustments to the basis of property at the time it is placed in service, sold, or otherwise disposed of by the taxpayer.

Improvements to Tangible Property

In the view of many tax practitioners, the heart of the final regulations lies in the rules it provides for distinguishing between expenses for repairs to tangible property and expenses for improvements to that property. Under the final regulations, an expenditure on tangible property must be capitalized if it improves a unit of that property. A unit of property is considered improved if the amounts paid by the taxpayers for the property after it is placed in service result in a betterment or restoration of it, or an adaptation of the property to a new and different use. In general, any expenditure on existing property that does not satisfy any of the three tests is considered a deductible repair.

An expenditure on a unit of tangible property leads to its betterment if the expenditure has one or more of the following effects:

- improves a condition or defect that existed before the taxpayer acquired the property, or arose during its production, regardless of whether the taxpayer was aware of the condition or defect at the time of acquisition or production;
- expands the size of a unit of property;
- increases the capacity of the property; or
- is reasonably expected to boost the productivity, efficiency, strength, or quality of the unit of property.

Under the regulations, tangible property is restored if the taxpayer engages in at least one of the following activities:

- replaces a component of the property and deducts a non-casualty loss for that component;
- replaces a component of a unit of property and realizes a capital gain or loss by selling or exchanging the component;
- repairs damage to the property caused by a casualty and makes a basis adjustment to the property to reflect the casualty loss or an any insurance payments;
- restores a unit of property to its "ordinary operating efficiency" after it had fallen into a state of disrepair and was no longer capable of performing its intended functions;
- restores a unit of property to a like-new condition after it reached the end of its depreciation life under the MACRS or ADS; or
- replaces a part (or parts) that constitute a major component or substantial structural element of a unit of property.

Expenditures that adapt a unit of property to a new or different use also must be capitalized under the property improvement test. Under the final regulations, such an adaptation happens when a unit of property is altered so that it no longer performs in a manner that is consistent with the taxpayer's original use of it.

Safe Harbor for Building Improvements

As noted earlier, a building and its structural components are considered a unit of property apart from certain key systems commonly used in buildings, such as heating and air conditioning, plumbing, electrical systems, security systems, and elevators and escalators. These building systems are regarded as functionally independent from a building and thus are considered separate units of property under the final regulations.

In response to complaints from many small business owners that they lacked the resources to acquire the needed documentation to apply the improvement rules to their buildings and building systems, the final regulations establish a safe harbor for buildings with an unadjusted basis of $1 million or less owned by taxpayers with average annual gross receipts of $10 million or less.[10] Under the building improvement safe harbor, an eligible taxpayer may annually elect not to apply the improvement rules to a building (including its systems) she owns or leases if the total amount paid during the current tax year for repairs, maintenance, and improvements to the building does not exceed the lesser of $10,000 or 2% of the

[10] Donald T. Williamson, "Small Businesses and the Repair Regulations," *Tax Notes*, Mar. 24, 2014, p. 1345. This safe harbor is separate from the *de minimis* safe harbor for materials and supplies.

building's unadjusted basis, which cannot exceed $1 million. The IRS has the authority to adjust these dollar limits through published guidance. If expenditures for those purposes exceed the current dollar limit, no safe harbor is available for any amounts spent on the building during that tax year. The limit includes the amounts a taxpayer pays under the *de minimis* safe harbor and the routine maintenance safe harbor (see below).

To illustrate the practical effects of this safe harbor, assume that an eligible business owner owns an office building with an unadjusted basis of $750,000. In the current tax year, he pays a total of $6,000 for repairs, maintenance, and improvements to the building. As this amount does not exceed either $10,000 or 2% of the unadjusted basis ($15,000), the taxpayer can deduct the $6,000 in expenses under the safe harbor, provided they are ordinary and necessary and related to the taxpayer's trade or business.

Routine Maintenance Safe Harbor

Under the final regulations, the costs of performing routine maintenance on a unit of property such as the air conditioning and heating system of a building are currently deductible under a safe harbor.

Routine maintenance is defined as recurring activities that someone expects to perform as a result of using a unit of property intended to keep it in "ordinarily efficient operating condition." Examples of such maintenance are inspecting, cleaning, and testing building structures and their operating systems and replacing the damaged or worn-out parts of equipment with comparable and commercially available replacement parts.

Under the safe harbor, an amount paid for maintenance is deductible if it is for ongoing maintenance activities, and the activities relate to the owner's use of a unit of property. Thus, the safe harbor does not apply to scheduled maintenance that is done on an existing building or used equipment shortly after a taxpayer acquires it. In addition, the safe harbor applies only to maintenance activities that a taxpayer expects to perform more than one during the lifetime of the tangible property, at the time the property is placed in service. In the case of a building and its major systems, a taxpayer may deduct expenses for maintenance only if he expects to perform the activities at least twice during the 10 years after the taxpayer places the building or systems in service. The safe harbor continues to apply after a unit of property reaches the end of its class life under the MACRS; in the case of buildings and their major systems, the safe harbor applies to the period following the first 10 years of use by a taxpayer. In determining whether an activity qualifies for the safe harbor, the final regulations specify that IRS should consider the frequency with which the activity is done, industry practice, the recommendations of manufacturers of the property, and the experience of taxpayers.

Option to Capitalize Repair and Maintenance Expenses

The final regulations also make it possible for companies to capitalize their repair and maintenance expenses if they deem such treatment in their self-interest. The regulations do so by creating a safe harbor that allows taxpayers to harmonize their tax treatment of those expenses with their book policy toward them.

Instead of forcing companies to undergo a potentially complicated assessment of their expenditures on tangible property to determine which ones are currently deductible and which expenditures must be capitalized, the final regulations permit taxpayers to make an annual election to capitalize and depreciate, as a separate asset, any expenditure for repairs and maintenance. Such an election can be made only if a taxpayer capitalizes the expenditure under the method of financial accounting it uses to compute its business or book income. The election applies to all amounts paid for repairs and maintenance on tangible property that are treated as capital expenditures on the taxpayer's books and records for the tax year covered by the election. Once the election is made, amounts paid for repairs and maintenance is no longer currently deductible during the current tax year. In effect, the election works as a safe harbor because the IRS cannot challenge an electing taxpayer's treatment of a repair or maintenance expense as a capital expenditure.