

**ALLEGHENY TAX SOCIETY**

**REPAIR AND CAPITALIZATION  
EXPENDITURES**

**ANALYSIS OF THE FINAL REGULATIONS**

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## **BACKGROUND**

On September 13, 2013, the IRS issued final “repair” regulations under Section 162 and 263(a). The Service also re-proposed regulations under Section 168.

In general, the regulations provide the rules related to the treatment of payments to “acquire, produce, or improve” tangible property, and are generally effective for tax years beginning on or after January 1, 2014.

## **MATERIALS AND SUPPLIES**

The material and supply regulations are issued pursuant to Section 162. Reg §1.162-3.

- Define materials and supplies.
- Provide rules regarding the tax year for deduction.
- Provide an election to currently deduct de minimis amounts.
- Allow a taxpayer to elect to capitalize certain materials and supplies.
- Treat rotatable/temporary spare parts as deductible in the year of disposition or alternatively, upon installation.

### **Definition of Materials and Supplies**

Material and supplies are tangible property used or consumed in the taxpayer's business operations that are not inventory and include:

- A component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property.
- Fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in a taxpayer's operations.
- A unit of property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations.
- A unit of property that has an acquisition cost or production cost of \$200 or less.

The cost of nonincidental materials and supplies are deducted in the year used or consumed.

### **Incidental Materials and Supplies**

Incidental materials and supplies are materials and supplies that are carried on hand and for which no record of consumption is kept or for which physical inventories at the beginning and end of the tax year are not taken.

## **Rotables and Spares**

A rotatable spare part is a component of a unit of property which is installed on the property, removed from the property, repaired or improved, and either reinstalled on the same or other property or stored for later installation.

Temporary spare parts are components used temporarily until a new or repaired part can be installed and then are removed and stored for later (emergency or temporary) installation.

Rotatable and temporary spare parts are considered used or consumed in the tax year in which the parts are disposed of. Therefore, they are deducted in the disposition year.

However, the deduction is claimed in the year of installation if the taxpayer uses the optional method for accounting for rotatable and temporary spare parts.

If the optional method for rotatable spare parts is used, a deduction for the amount paid or incurred to acquire or produce the rotatable is claimed in the tax year that the rotatable is first installed.

The taxpayer includes in income and assigns a cost basis equal to the fair market value of the used, non-functioning part, and capitalizes the costs of repairing the part.

If the repaired part is later used as a replacement part in the taxpayer's equipment, the taxpayer deducts the basis of the part in the tax year it is re-installed.

This cycle continues until disposition of the part.

## **Effective Date Materials and Supplies**

Effective for years beginning on or after January 1, 2014. Early adoption permitted.

### **DE MINIMIS RULE**

The de minimis rule is a rule of administrative convenience designed to comport with conventional accounting practices. The rule applies if:

- The taxpayer has an applicable financial statement.
- The taxpayer has at the beginning of the tax year written accounting procedures treating as an expense for non-tax purposes the amounts paid or incurred for property
  - Costing less than a certain dollar amount, or
  - Property with an economic useful life of 12 months or less.

Taxpayers may deduct up to \$5,000 per invoice (or per item as substantiated by invoice). This

amount is reduced to \$500 in the absence of an applicable financial statement.

This is a safe harbor. Facts and circumstances might dictate a larger amount.

Taxpayers must include statement with return. The election is annual, but applies to all materials and supplies. Section 263A still applies to expensed items.

Effective January 1, 2014.

### **Example**

Taxpayer has an applicable financial statement and a written policy to deduct \$5,000 or less. Taxpayer purchases 1,000 computers for \$5,000 each, substantiated by an invoice. Taxpayer may deduct each computer as de minimis, but would not be able to use the safe harbor if the computers were over \$5,000.

### **Another Example**

Taxpayer has no applicable financial statement, but has a written policy to deduct \$500 or less. Taxpayer purchases 10 computers at \$600 each. Taxpayer cannot use the safe harbor because each item is above \$500, but would be able to deduct if computers were \$500 each.

### **A Third Example**

Taxpayer has an applicable financial statement with a written policy to deduct amounts under \$5,000. Taxpayer purchases 10 wireless routers, and the invoice includes a price per router of \$2,500 and \$20,000 total for delivery and installation.

\$20,000 allocated on a pro-rata basis to each of the 10 routers. The total cost for each router is \$4,500 and can be deducted under the de minimis rule.

## **AMOUNTS PAID TO IMPROVE TANGIBLE PROPERTY**

The improvement/repair regulations under Reg §1.263(a)-3 provide rules for distinguishing between expenditures that are repairs and expenditures that are capital improvements.

The regulations require capitalization of amounts paid to improve a unit of tangible property.

### **Unit of Property - Personality**

A unit of property consists of a group of functionally interdependent components, such as the

parts of a machine, with the machine being treated as a unit of property.

Generally the larger the unit of property, the more likely that work on that property will be considered a deductible repair.

### **Unit of Property - Buildings**

Each building system in the following list is treated as a separate unit of property. The building structure (for example, the building shell and all other structural components that are not part of a building system) is treated as a separate unit of property.

- Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures).
- Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from property line to and between buildings and other permanent structures).
- All escalators.
- All elevators.
- Fire-protection and alarm systems.
- Security systems.

A unit of property is improved if amounts are paid for activities performed after the unit of property is placed in service by the taxpayer resulting in:

- A **betterment** to the unit of property;
- A **restoration** of the unit of property; or
- **Adaptation** of the unit of property to a new or different use. Reg §1.263(a)-3(d).

### **Betterments**

A capitalized betterment is an expenditure that:

- Ameliorates a material condition or defect that existed prior to the taxpayer's acquisition of the unit of property whether or not the taxpayer was aware of the condition or defect at the time of acquisition.
- Results in a material addition (for example, physical enlargement, expansion, or extension) to the unit of property
- Results in a material increase in capacity, productivity, efficiency, strength, or quality

of the unit of property or the output of the unit of property.

The replacement of a part of a unit of property with an improved, but comparable part does not, by itself, result in a betterment to the unit of property if it is not practical to replace the part with the same type of part.

### **Examples of Betterments**

A 10% increase in energy efficiency of 2 out of 10 roof mounted HVAC units is not considered to be a material increase in efficiency.

Conversely, a 50% reduction in energy and power costs from new insulation is material increase in efficiency.

Drive-through service area added to a building will be considered to be a material addition (physical expansion, extension, and addition of a major component).

### **Restorations**

An amount is paid to restore a unit of property if:

- The expenditures return a unit of property to its ordinary efficient operating condition after the property has deteriorated to a state of disrepair and is no longer functional for its intended use.
- The expenditures rebuild a unit of property to a like-new condition after the end of its class life.

An amount is also paid to restore a unit of property if the expenditures are for the replacement of a part or a combination of parts that:

- Comprise a major component or a substantial structural part of a unit of property, or
- Perform a discrete and critical function in the operation of the unit of property.

An amount is also paid to restore a unit of property if:

- A component of the unit of property is replaced and a loss is deducted or a gain or loss is realized by selling or exchanging the replaced component.
- A casualty loss resulting in any basis adjustment is claimed on the repaired unit of property.

### **Examples of Restoration**

- Replacement of a chiller in an HVAC system.

- Replacement of an entire sprinkler system.
- Replacement of all wiring in building.
- Replacement of all restroom fixtures.
- Replacement of 200 of 300 windows.
- Replacement of 100 of 300 windows (windows cover 90% of building).
- Replacement of 40% of sq ft of flooring.

#### **Examples that are Not a Restoration**

- Replacement of 1 of 3 furnaces.
- Replacement of 3 of 10 roof HVAC units.
- Replacement of 30% of electrical wiring.
- Replacement of 8 of 20 sinks.
- Replacement of 100 of 300 windows (300 windows cover 25% of building surface area).
- Replacement of 10% of sq ft of flooring
- Replacement of 1 of 4 elevators.

#### **Adaptation To A New Or Different Use**

In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time it was originally placed in service by the taxpayer.

### **OTHER ASPECTS OF THE REGULATIONS**

#### **Routine Maintenance Safe Harbor**

The costs of performing certain routine maintenance activities are currently deductible under a routine maintenance safe harbor.

Under the safe harbor, an amount paid is deductible if it is for ongoing activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition.

The activities are routine only if, at the time the unit of property is placed in service, the taxpayer reasonably expects to perform the activities more than once during the class life of the unit of property.

The final regulations provide that the routine maintenance safe harbor applies to buildings if, at the time the unit of property is placed in service, the taxpayer reasonably expects to perform the activities more than once during the 10-year period beginning with the placed-in-service date.

Factors to be considered in determining whether a taxpayer is performing routine maintenance

include the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience. Activities include inspecting, cleaning, testing and replacement of damaged parts.

### **Building Safe Harbor**

A qualifying taxpayer is permitted to make a safe harbor election for buildings. A qualifying taxpayer is one with gross receipts of \$10,000,000 or less.

A taxpayer may elect not to apply the improvement rules if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of:

- \$10,000
- 2 percent of the unadjusted basis of the building.

Eligible building property includes a building unit of property that is owned or leased by the qualifying taxpayer, provided the unadjusted basis of the building unit of property is \$1,000,000 or less.

## **ACCOUNTING METHOD CHANGES**

The final regulations provide that, except as otherwise stated, a change to comply with the final regulations is a change in method of accounting to which the provisions of Sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in the final regulations must secure the consent of the Commissioner.

Separate procedures will be provided under which taxpayers may obtain automatic consent for a taxable year beginning on or after January 1, 2012, to change to a method of accounting provided in the final regulations.

## **PROPOSED REGULATION 1.168(i)-8 DISPOSITIONS OF STRUCTURAL COMPONENTS**

On September 19, 2013, the Internal Revenue Service issued proposed regulations related to dispositions of structural components of a building and components of Section 1245 property.

The proposed regulations provide that a building (including its structural components) is the asset for disposition purposes.



A taxpayer desiring to claim a loss on a retired component outside of a general asset account is now required to make a partial disposition election. This rule applies to:

- Structural components of a building
- Components or portions of Section 1245 assets.

Partial disposition rule is nonelective, and must be applied, in the case of a:

- Casualty
- Like kind exchange.
- Involuntary conversion.
- Certain nonrecognition transactions, such as Section 332, 351 or 721.
- Sale of the asset.

Election can only be made in the year of disposition, with the exception of situations where a taxpayer deducts a replacement cost as a repair and later has that item adjusted by the IRS.

Identification of asset disposed:

- General rule is specific identification.
- If this is not practical, then FIFO is generally required.

Basis of asset disposed of:

- General rule is adjusted depreciable basis at disposal.
- Any reasonable method if general rule is impractical.

### Example

Suppose taxpayer replaced 60% of its roof in 2012, capitalized the replacement and made a partial disposition election. In 2022, suppose taxpayer then replaces 55% of the roof of the building, capitalizes the replacement and makes the partial disposition election for the replaced portion. Taxpayer cannot determine from its records whether the 55% is part of the 60% replaced in 2012 or whether it is part of the original 40% of the roof. Taxpayer may use the FIFO method to identify the asset disposed of.

In this case the building is the asset (including original roof) and 60% of roof replacement in 2012 is a separate asset. Thus, the taxpayer is considered to have disposed of the remaining 40% of the original roof (FIFO). At this point, the taxpayer has accounted for 40 of the 55% replaced in 2022. The remaining 15% will come from the 2012 replacement, which was 60% of the roof. Put another way, the taxpayer will be deemed to have disposed of 1/4 of the 60% replacement that occurred in 2012.

Original Roof	100%
Replaced	(60%)
Remaining	<u>40%</u>

<u>Two Assets</u>		<u>Disposed in 2022</u>
Original	40%	40%
2012 Replacement	60%	<u>15%</u>
2022 Replacement		<u>55%</u>