Trust earned.
FreedMaxick™

The Final Tangible Property Regulations

On Sept. 19, 2013, the IRS and Treasury released the final tangible property regulations (T.D. 9636). These regulations provide guidance for taxpayers in determining whether an expenditure constitutes an amount paid to acquire, produce, or improve tangible property that must be capitalized under Code Section 263(a), or constitutes a deductible repair under Code Section 162(a). At the same time, the IRS and Treasury issued new proposed regulations for dispositions of MACRS property and general asset accounts.

Unit of Property

The UOP is the basis on which it is determined whether an amount is paid to improve, repair, or maintain a UOP. The UOP is comprised of all components that are functionally interdependent. In the case of buildings, the UOP consists of the following: structural components (roof, walls, windows, floors, doors, etc.), HVAC systems, gas distribution systems, plumbing systems, electrical systems, escalators, elevators, fire protection and alarm systems, and security systems. In the case of a tenant, the UOP consists of the portion of the building and building systems covered by the lease.

If a component of a UOP is assigned to a different recovery period or depreciation method than the UOP of which it is a part, then the component is treated as a separate UOP. For example, components of a building that are reclassified as personal property and depreciated over a shorter recovery period than the building are a separate UOP from the building.

Amounts Paid to Improve Tangible Property

The final regulations require the capitalization of expenditures that result in an improvement to a UOP. An improvement results when there is a betterment, restoration, or adaptation of a UOP. A taxpayer is required to capitalize all direct costs and the indirect costs that directly benefit or are incurred by reason of an improvement.

In the case of buildings, the improvement rules are applied to each major component or substantial structural part (roof, walls, windows, floors, doors, etc.). All facts and circumstances, including the quantitative or qualitative significance of the part or combination of parts in relation to the UOP, are taken into account in determining whether a major component of a UOP has been replaced. A major component is a part or combination of parts that perform a discrete and major function in the operation of the UOP. An incidental component is not a major component even if it performs a discrete and critical function (e.g., a switch to a machine).

In the case of buildings, the replacement of a significant portion of a major component of the building structure or a building system is treated as a restoration. A substantial structural part of a building UOP is a part or combination of parts that comprise a large portion of the physical structure of the building UOP. For example, windows are major component and a substantial structural part of a building. Therefore, the replacement of a significant portion of the windows may constitute an improvement to a building.

Safe Harbor for Small Taxpayers with Buildings

The final regulations provide an annual election for small taxpayers that own buildings. The election permits the small taxpayer, defined as $10 million or less in annual gross receipts, to expense all amounts incurred during the taxable year to repair, maintain, and improve the building provided the original cost basis of the building (excluding land and improvements thereto) does not exceed $1 million.

The amount that can be expensed is limited to the greater of 1) $10,000, or 2) 2% of the original cost basis of the building. If the total costs incurred to repair, maintain, and improve the building (including amounts expensed under the de minimis safe harbor and as routine maintenance) exceed this amount, then the safe harbor election does not apply. The election is made on a building-by-building basis, for each eligible building that is owned by the small taxpayer.

Dispositions of MACRS Property

The IRS replaced the temporary regulations issued in December 2011 with new proposed regulations that make significant changes to the rules on dispositions of tangible property. The most significant change allows taxpayers to elect a "partial disposition" of structural components of buildings. Taxpayers can claim a tax deduction for the retirement of a structural component of a building or any component of a structural component. For example, if a significant portion of the windows are replaced and required to be capitalized, there would be an opportunity to dispose of the windows that were replaced.

A disposition of tangible property occurs when an asset is sold, exchanged, retired, physically abandoned, destroyed, or transferred to a supplies, scrap, or similar account. The UOP rules discussed above do not apply when determining whether an asset has been disposed. A capitalized improvement or addition added to an asset after the taxpayer places an asset in service is treated as a separate asset for depreciation and disposition purposes. The partial disposition election does not apply in the case of a separately depreciated asset because the entire asset is disposed of. However, the partial disposition election can apply to the disposition of a portion of a separately depreciated asset.

The Evolution of the Unit of Property Concept

The examples contained in the final regulations are based on the court cases that have established whether expenditures are capital improvements or deductible repairs. For example, in 2003 Federal Express incurred costs to rebuild jet engines to keep the jet airplane in its normal operating condition. The IRS argued that the cost of rebuilding a jet engine should be capitalized and depreciated based on treating the engine as a separate UOP. Federal Express argued that the costs were regular maintenance incurred to maintain the Jet airplane. The court agreed with Federal Express treating the jet airplane as a single UOP since the engines were necessary for the jet airplane to operate. As a result, Federal Express was allowed to expense the cost of rebuilding the jet engines since the costs were incurred for normal ongoing maintenance to keep the jet airplane in its normal operating condition.

This decision established tax planning for costs incurred to repair and maintain buildings by treating the entire building as the UOP. Taxpayers were taking the position that major expenditures such as replacing the entire roof system including decking on a building constituted a deductible repair to keep the building in its normal operating condition. As a result, the IRS and Treasury determined they needed to provide specific guidance on the determination of a UOP, especially as it related to buildings. The result was the UOP rules for buildings contained in the final tangible property regulations treating the building structure, structural components, and eight building systems as a separate UOP. The smaller the UOP, the more likely it is that an expenditure results in a capital improvement instead of a deductible repair or maintenance expense.

The Evolution of the Final Tangible Property Regulations and Accounting Method Changes

Historically, the Code requires the capitalization of amounts paid for new buildings, improvements, and betterments that increase the value of property or restore property. The regulations have historically required the capitalization of amounts that add to the value, or substantially prolong the useful life of property, or adapt property to a new or different use. The regulations allowed for expensing amounts paid for incidental repairs and maintenance which resulted in controversy between taxpayers and the government. In fact, the United States Supreme Court recognized the highly factual nature of determining whether expenditures are for capital improvements or for ordinary repairs (Welch vs. Helvering, 290, U.S., 111, 114 (1933), Deputy vs. Dupont, 308, U.S. 488, 496 (1940)).

Over the years, the courts have determined whether expenditures constitute capital improvements or repairs and maintenance expenditures. For example, the courts determined that repair and maintenance expenditures keep property in an ordinary and efficient operating condition over its probable useful life whereas capital expenditures are for replacements, alterations, improvements, or additions that appreciably prolong the useful life, materially increase its value, or make it adaptable to a different use. The relevant distinction is whether the expenditure was made to "put" or "keep" property in efficient operating condition. The courts determined that if the expenditure merely restores property to the state it was in before the situation prompting the expenditure arose and does not make the property more valuable, more useful or longer-lived, then the expenditure is a deductible repair. In contrast, a capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property.

The standards established by the Code, regulations, case law, and administrative guidance have led to uncertainty and controversy over capital expenditures vs. repairs and maintenance expenditures. As a result, on January 20, 2004, the IRS and Treasury announced in Notice 2004-6 their intention to propose regulations providing guidance in this area. On August 21, 2006, the IRS and Treasury published proposed amendments to the regulations relating to amounts paid to acquire, produce or improve tangible property. On March 10, 2008, the IRS and the Treasury withdrew the 2006 proposed regulations and issued new proposed regulations. On December 27, 2011, the IRS and Treasury withdrew the 2008 proposed regulations and issued new proposed and temporary regulations effective for taxable years beginning on or after January 1, 2012. On September 19, 2013, the IRS and Treasury withdrew the proposed and temporary regulations and issued final regulations for amounts paid to acquire, produce, or improve tangible property (T.D. 9636), and issued new proposed regulations for dispositions of MACRS property (property placed in service after 1986), and general asset accounts.

Taxpayer Compliance Initiative – The Practical Application

The final regulations are effective for taxable years beginning on or after January 1, 2014 with the option of adopting sections of these regulations for taxable years beginning on or after January 1, 2012. The IRS and Treasury expect all taxpayers impacted by these regulations to file Form(s) 3115 to show their efforts to comply with the final rules. Since compliance is mandatory, taxpayers should begin to review their accounting methods and procedures as soon as possible and consider incorporating method changes and elections when filing their 2013 tax returns. For example, taxpayers should apply the new UOP rules to expenditures incurred in 2013 and capitalize or expense these amounts accordingly.

Every taxpayer is required to conduct a review of their accounting for tangible property and adopt new procedures and method changes based on their findings. It is likely that many building owners have historically capitalized repairs that are now eligible for a tax deduction using the Code Section 481(a) regime. In addition, amounts capitalized in prior years as a result of a capital improvement projects most likely will provide a tax deduction under the Code Section 481(a) regime.

Studies focusing on engineering-based reviews tied to a repair and maintenance analysis help defer taxes, improve cash flow, and provide a benchmark for additional deductions in the future by segregating the long-life property into eight building systems as required in the regulations (plumbing, electrical, HVAC system, etc.). As owners begin to comply with the new repair and maintenance regulations, there will be significant tax benefits available to them by segregating these systems. Many will be able to dispose of structural improvements that were historically capitalized for tax purposes. Others may find that the cost segregation study allows them to qualify for the small taxpayer safe harbor, reducing building costs below the $1 million threshold.

A properly performed R&M study provides the cost detail for each of the building's major structural components, so when it is repurposed, repaired, or disposed of; the owner has defined values for those components. Tracking these costs allows owners to properly follow the new regulations and present tax-saving opportunities over the life of the building. The study will provide the detail necessary to support the claimed tax deductions and to document compliance with the final regulations.

Authors:
Don L Warrant, CPA
Jennifer A Birkemeier, CPA