

Tax Impacts Bulletin

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Act Now or Pay Later: Unraveling the New “Repair” Regulations

After years of waiting, the IRS finally carried through with their promise to provide detailed guidance on which costs must be capitalized. The regulations issued also provide the potential to accelerate certain deductions on costs previously capitalized, just in time for the higher tax rates to take effect.

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HERE'S A QUICK SUMMARY OF THE PROVISIONS WE THINK ARE MOST LIKELY TO IMPACT YOU

On September 13, 2013 the IRS released final regulations offering significant guidance related to the capitalization of tangible property. For years the issue of those costs that can be expensed versus capitalized has been a source of continuous conflict between the IRS and taxpayers. The regulations, which will impact virtually all businesses, become effective for tax years beginning on or after January 1, 2014, but may be adopted early for tax years beginning on or after January 1, 2012. This bulletin explains the new capitalization and expensing rules with an eye toward helping you plan for the changes and decide when to implement the new rules in your business—which may mean **action before the end of 2013**.

OVERVIEW

The road to the final regulations has been an arduous one, and has involved significant revisions as the IRS solicited and received feedback. The good news is the IRS listened and considerably altered many aspects from the temporary regulations. The bad news is the regulations as issued still have an unusually large scope and will affect taxpayers in numerous ways. We estimate that the average business will need to make **4-6 changes in their accounting method** to comply with the regulations. The purpose of the regulations was to accumulate and formalize numerous court cases on the capitalization of tangible property, and to provide examples of how to implement the 200+ pages of regulations. The following discussion provides an introduction to the most common issues that will need to be addressed.

HOW DOES THIS AFFECT MY REAL PROPERTY?

The treatment of costs expended on real property is the most extensive issue covered in the regulations. The fundamental concept introduced is defining a “Unit of Property” (UOP) as the reference for expense vs. capitalization analysis. While not a new concept, the regulations brought UOP to the forefront and significantly expanded its use as the primary criteria in

determining when expenditures can be written off. For buildings, the UOP consists of nine separate building systems:

- Building Structure (or Shell)
- HVAC
- Plumbing
- Gas Distribution
- Electrical
- Elevators
- Escalators
- Fire Protection
- Security Systems

For leased property, the UOP for tenants consists of the leased portion of the same nine building systems. As costs are incurred for these systems, the expenditures are capitalized to the extent that the work resulted in a “betterment,” “adaptation” or “restoration” (or **BAR**) of the UOP. The regulations provide the standards for capitalization in these areas:

Betterments result in a capital asset if:

- A pre-existing material condition or defect is ameliorated;
- A material addition or expansion is realized; or
- A material increase in the productivity, efficiency, strength, quality or output is expected.

Adaptations result in a capital asset if:

- A new or different use results from the improvements to a UOP that is not consistent with its original use.

Restorations result in a capital asset if:

- A UOP is no longer functional for its intended use and is returned to its ordinarily efficient operating condition;
- A UOP is rebuilt to like-new condition at the end of its class life;
- A major component or substantial structural part of a UOP is replaced; or
- A disposition loss was taken on the original UOP.

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The regulations provide numerous examples of how the above are to be applied, both quantitatively and qualitatively, to the nine separate building components for each UOP.

Safe Harbor for Routine Maintenance

There are a number of taxpayer-friendly aspects in the regulations. A major change from the temporary regulations is the introduction of a safe harbor for routine maintenance on buildings. Amounts incurred to keep a UOP in its ordinarily efficient operating condition may be expensed if the maintenance is expected to be performed more than once in a 10 year period after the building was placed in service. This treatment is not allowed if the betterment, restoration or adaptation standards as detailed above are met, but the UOP testing covers the same nine separate building systems. This safe harbor for routine maintenance also applies to all other fixed assets if the maintenance is expected to be performed more than once over its applicable class life.

A second safe harbor is allowed for maintenance costs for certain small taxpayers. To qualify, the taxpayer's average annual gross receipts for the preceding 3 years cannot exceed \$10M and the unadjusted basis of the building owned or leased cannot exceed \$1M. If these requirements are met, the total costs incurred for repairs and maintenance can be expensed if they do not exceed the lesser of \$10,000 or 2% of the unadjusted basis of the property. While the 10 year performance standard is not necessary for this safe harbor, if the total repair and maintenance costs exceed the threshold, all costs are subject to the normal capitalization rules.

Dispositions of Property

The final taxpayer-friendly provision in the regulations allows for partial disposition of components of the building system's UOP in certain situations. When an improvement to a UOP must be capitalized, the original component is deemed retired. Before these regulations were enacted, taxpayers were essentially required to depreciate two of the same asset, even though one of them was no longer physically present. The taxpayer may now elect to dispose of the retired component in the year replaced. This provision **opens two opportunities** for taxpayers to **clean up their depreciation schedules one-time and take losses in either 2013 or 2014**. If any improvements to a UOP were capitalized after the asset was originally placed in service, the above rules on betterments, adaptations and restorations may be applied to prior years to determine if the improvement qualified as a repair under the new regulations. If so, then any remaining depreciable basis can be written off. If capitalization of the improvement is still required under the regulations, then a partial disposition election can be made on the portion of the original building basis allocated to this component. The regulations provide allowable methods in determining the amount of basis to allocate upon disposition to assist in calculating the allowable loss.

HOW DOES THIS AFFECT MY OTHER FIXED ASSETS?

The final regulations also address capitalization standards for UOPs other than buildings, such as computers, furniture, equipment, or other personal property. In this context, the UOP capitalized as a fixed asset generally consists of all the components that are functionally interdependent upon each other. The de minimis safe harbor for UOPs other than buildings is \$500 per item, per invoice, if the taxpayer has a written capitalization policy consistently applied on their financial statements. This de minimis safe harbor increases to \$5,000 if the taxpayer has audited (but not reviewed) financial statements, or a financial statement that must be submitted to a federal or state governmental agency. This safe harbor is an annual election that is filed with the tax return.

Also addressed is the treatment of incidental and non-incidental materials and supplies, which are generally non-inventory items expected to be consumed in 12 months or less. Incidental materials and supplies are those for which no records are kept of amounts on hand. These costs can continue to be expensed when purchased, which remains unchanged in the new regulations. Non-incidental materials and supplies are those where consumption is tracked on an on-going basis. Expense is allowed for non-incidental materials and supplies only in the year when consumed, unless the de minimis safe harbor is elected. This safe harbor for non-incidental materials and supplies allows items under \$200 to be expensed when purchased.

WHAT SHOULD I BE DOING NOW?

A great start is talking to your CPA about how these regulations may affect you. The regulations are required to be applied for all tax years beginning on or after January 1, 2014. There may be instances where it is beneficial to adopt earlier, so be sure to address the following issues before the end of 2013:

- Create or revise your written capitalization policy
- Evaluate your materials and supplies policies
- Analyze your depreciation schedules for capitalized building improvements or other "ghost" assets that may be written off
- Analyze your depreciation schedules for incorrect lives or methods
- Assess current policies for tracking repairs and maintenance expenses and consider revising to align with the final regulations

For any questions or additional clarification, please contact your tax advisor, or a **Perkins tax expert**.



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