



Repairs Regulations Require Review of Accounting for Capital Assets

On December 23, 2011, the Government released long-awaited temporary and proposed regulations to clarify the difficult distinctions between currently deductible business repairs and capital improvements. These regulations replace prior proposed regulations issued in 2006 and 2008.

Overview

Highlights of the new lengthy and complex regulations include:

- Modifications in the determination of units of property for buildings and their primary components;
- Changes in the deductibility of unrecovered costs of structural components following improvement or retirement;
- Modifications and expansions of the definition of materials and supplies;
- Revised de minimis rules;
- Revised rules for accounting for assets to which section 168 applies.

In general, under Code section 263(a) a taxpayer must capitalize amounts paid or incurred for: (1) permanent improvements or betterments which increase the value of property; (2) restoration of property; or (3) adapting property to a new or different use. But amounts paid for incidental repairs and maintenance are deductible business expenses under Code section 162. It is not always easy to distinguish between a repair and a capital expenditure.

The temporary regulations provide general rules for capital expenditures, for amounts paid for the acquisition or production of tangible property (including de minimis rules), rules for expenditures

to improve tangible property (including a safe harbor for routine maintenance), and accounting rules for MACRS assets.

Proposed Regulation Changes

The temporary regulations generally retain the basic framework from the 2008 proposed regulations that treat a building and its structural components as a single unit of property. But they now require the test for whether an expenditure is a capitalizable improvement to be applied separately to the primary components of a building—i.e., the building structure or any specifically defined building system (such as HVAC, plumbing, electrical, etc). Many companies filed accounting method changes since 2006 to treat the building as the unit of property and deducted amounts paid for HVAC, roof replacements and remodels. Companies will now need to reevaluate their positions under the new regulations.

If the cost of an improvement is capitalized, it must be depreciated as a new asset and recovered over the life of the improved property. The 2008 proposed regulations did not permit taxpayers to recognize losses upon the retirement of the old property following an improvement, which resulted in simultaneously depreciating multiple portions of the same property. The good news is that the new regulations address this problem by expanding the definition of a disposition to include retirements of structural components of a building, although a careful analysis is still required.





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Under the new regulations, materials and supplies include:

- Components acquired to maintain, repair or improve a unit of tangible property;
- Fuel, lubricants, water, and similar items reasonably expected to be consumed in 12 months or less;
- A unit of property costing \$100 or less;
- A unit of property with a useful life of 12 months or less;
- Rotatable or temporary spare parts.

The new regulations continue to allow taxpayers to deduct the cost of materials and supplies in the year purchased if they meet revised de minimis rules. These rules provide that taxpayers must: (i) have an “applicable financial statement”; (ii) have written accounting procedures treating as an expense for non-tax purposes amounts paid for property costing less than a certain amount; (iii) actually follow these written procedures; and (iv) meet a new overall ceiling on expenditures for materials and supplies. The ceiling is defined as the greater of (i) .1% of the taxpayer’s taxable gross receipts for the year, or (ii) 2% of the taxpayer’s total depreciation and amortization expense for the year as determined in its applicable financial statements.

In addition, taxpayers may now use an optional method of accounting for rotatable parts, which provides for a deduction of the new part in the year of installation, with a corresponding income inclusion equal to

the fair market value of the replaced part.

The new regulations revise the rules for accounting for MACRS property by providing that a taxpayer may generally choose to treat each asset as a single asset account or by combining two or more assets in a multiple asset account. Each multiple asset account must include assets that have the same depreciation method, recovery period and convention, and are placed in service in the same taxable year.

Effective Date

The temporary regulations generally apply to tax years beginning on or after January 1, 2012 and are considered a change in method of accounting. The IRS and Treasury are expected to release procedures under which taxpayers may obtain automatic consent when implementing these changes.

Action Steps

Not surprisingly, the temporary regulations contain numerous other provisions, including special rules, exceptions, safe harbors, and examples. Taxpayers should review these regulations and their accounting procedures and practices to ensure that they avoid the many traps—and capture the opportunities—contained in the regulations. TPC’s accounting method experts are available to assist you with this important analysis.

CONTACT INFORMATION

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