



Temporary Repair Regulations

On December 23, 2011, the Treasury Department and IRS released the long-awaited repair regulations in temporary (TD 9564) and proposed (REG-168745-03) form (the temporary regulations). These temporary regulations contain the standards for determining whether and when a taxpayer must capitalize costs incurred in acquiring, maintaining, or improving any tangible property.

Changes in Method of Accounting

The temporary regulations are generally effective for tax years beginning on or after January 1, 2012. All taxpayers that acquire, produce or improve tangible property will likely have to change their method of accounting to conform to the temporary regulations. This includes those who have filed previous 3115's under either case law or the 2008 proposed regulations and all other taxpayers that capitalize applicable costs. The temporary regulations require taxpayers to evaluate their current method of accounting for repairs to determine what changes, if any, are required to conform to these new rules. Taxpayers that currently use a more favorable method of accounting for repairs than permitted in the new temporary regulations will likely have to make a positive 481(a) adjustment when the new 3115 is filed for the 2012 tax year. This 481(a) will reverse some the benefit attained from the accounting method used based on the proposed regulation. It is anticipated that sometime in January, the IRS will issue two related revenue procedures that will provide transition rules for changing to methods described in the temporary regulations. For taxpayers that have not previously filed a 3115, a potential benefit exists under the current guidance as discussed below (see *Dispositions*). A notice and comment period has been provided before the regulations are finalized. Comments are due by March 26, 2012 and the public hearing has been scheduled for April 4, 2012.

Although the temporary regulations retain many of the rules in the 2008 proposed regulations, the temporary regulations create many new rules that are significantly different relative to prior law and the 2008 proposed regulations. The release of this new temporary regulation effectively withdraws the 2008 proposed regulations.

Key Highlights

- Unit of property is now segregated to "component systems" for buildings.
- Reduces the scope of what qualifies under case law and redacted 2008 proposed regulations.
- Provides rules for "component system" disposal losses.
- Clarifies de minimis rule: must be a deductible repair on the applicable financial statement.
- New procedures are forthcoming on 3115's. These procedures will apply to all taxpayers!



Unit of Property

The definition of the “unit of property” is very important for any “repairs” study because it serves as the reference point when the capitalization rules are applied. Generally, the larger the unit of property, the more likely the capitalization rules will result in amounts paid being treated as a deductible repair.

Buildings and Structural Components

The temporary regulations retain the general rule from the 2008 proposed regulations that define the unit of property for building property as the building and its structural components. However, the temporary regulations make very significant modifications to the application of the improvement standards to buildings as compared to the 2008 proposed regulations. The temporary regulations now require that a taxpayer apply the improvement standards separately to the building (including its structural components) and any specifically defined “building system” (as described below).

The temporary regulations define building systems to include:

1. heating, ventilation and air conditioning (HVAC) systems;
2. plumbing systems;
3. electrical systems;
4. escalators;
5. elevators;
6. fire protection and alarm systems;
7. security systems; and
8. gas distribution systems.

Therefore, if a repair is an improvement relative to a defined building component or building system, it must be treated as an improvement to the entire building.

For example, under the temporary regulations an amount paid to replace the roof of a building is measured against the building structure rather than the entire building and is more likely to be characterized as an improvement because it results in a restoration of a building structure. Additionally, an amount spent to replace a component of the HVAC system is more likely to be characterized as an improvement because it results in a betterment to a building system). As discussed in further detail below (see *Replacement of Major Component or Substantial Structural Part*), the temporary regulations significantly modify the restoration standard that requires the replacement of a major component or substantial structural part to be capitalized. The temporary regulations remove the 2008 proposed rules that provide this standard did not apply until after the end of the depreciable recovery period and after either: (1) 50% of the physical structure was replaced, or (2) 50% of the replacement value of the unit of property was replaced.



Real and Personal Property Other Than Buildings

For real and personal property other than buildings, the temporary regulations generally define the unit of property as consisting of all components of the unit of property that are functionally interdependent unless the taxpayer used a different depreciation method or recovery period for a component at the time it was placed into service.

For plant property, the temporary regulations retain the rule from the 2008 proposed regulations that the unit of property is generally comprised of each component (or group of components) within the plant that performs a discrete and major function or operation within functionally interdependent machinery and equipment.

For network assets, the temporary regulations retain the rule from the 2008 proposed regulations that a unit of property is determined by the taxpayer's facts and circumstances. The functional dependence test is not applicable for network assets.

Leasehold Improvements

The 2008 proposed regulations did not address the unit of property for leased property where the taxpayer is the lessee. The temporary regulations define that the lessee's unit of property for leased buildings is each building and its structural components (or portion thereof) subject to the lease. The temporary regulations also provide that an amount is paid for an improvement to a leased building if the amount paid results in an improvement to the leased building structure or any of the leased building systems. Because a lessee improvement involves the acquisition or production of a new and distinct interest in property and this property interest is often different from the underlying leased property, amounts paid for a lessee improvement as the acquisition or production of a new unit of property, rather than an improvement to the underlying property. Meanwhile, a lessor improvement is treated an improvement to the underlying property and is not treated as the acquisition or production of a new unit of property.

Improvement to Tangible Property

The temporary regulations provide taxpayers with guidance on the treatment of amounts paid to improve tangible property. The temporary regulations require a taxpayer to capitalize amounts paid to improve a unit of property if the amount:

1. results in a **betterment** to the unit of property;
2. results in a **restoration** to the unit of property; or
3. adapts the unit of property to a **new or different use**.



Betterments

In general, the temporary regulations provide that an amount would result in a betterment if it:

- ameliorates a material condition of defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of the acquisition or production;
- results in a material addition (including a physical enlargement, expansion, or extension) to the unit of property; or
- results in a material increase in capacity (including additional cubic or square feet), productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.

The rules in the temporary regulations for determining whether an amount results in a betterment to a unit of property include one major change. The temporary regulations specifically provide that an amount results in a betterment to a building if it results in a betterment to a structural component or a building system, instead of to the building as a whole. The temporary regulations include more examples than were contained in the 2008 proposed regulations to illustrate the application of the betterment rules. The examples include three situations involving amounts incurred by retail stores:

Example 6 provides an example of a retailer that periodically refreshes the appearance and layout of its stores by changing their layouts, relocating lighting fixtures, reconfiguring display tables and racks, and making minor repairs in order to remain competitive and attract customers. The temporary regulations conclude that this type of building refresh does not result in a betterment and therefore the retailer is not required to capitalize the related costs.

Example 7 assumes the same facts as Example 6 except, in the course of the refresh of the retailers' store buildings, the retailer removes and replaces the bathroom fixtures (the toilets, sinks, and plumbing fixtures) with upgraded bathroom fixtures in all of the restrooms in the retail buildings in order to update the restroom facilities. As part of the update to the restrooms, the retailer also pays amounts to replace wall and floor tiles that were removed or damaged during the installation of the new plumbing fixtures. The temporary regulations conclude that the retailer must treat the amounts paid to replace the bathroom fixtures with upgraded fixtures as a betterment because they result in a material increase in the quality of each plumbing system. Accordingly, the retailer in Example 7 must capitalize amounts paid to upgrade the restrooms. However, the retailer is not required to capitalize the amounts described in Example 6 to refresh the appearance and layout of its stores.

Example 8 assumes the same facts as Example 6, but assumes that the work performed to refresh the stores directly benefits or was incurred by reason of a substantial remodel to the



retailer's store buildings. In addition to the reconfiguration, cosmetic changes, repairs, and maintenance activities performed in Example 6, the retailer performs significant additional work to alter the appearance and layout of its stores in order to increase customer traffic and sales volume. The retailer pays amounts to upgrade the buildings' structures. This work includes removing and rebuilding walls to move built-in changing rooms and specialty departments to different areas of the stores, replacing ceilings with acoustical tiles to reduce noise and create a more pleasant shopping environment, rebuilding the interior and exterior facades around the main doors to create a more appealing entrance, replacing conventional doors with automatic doors, and replacing carpet with ceramic flooring. The retailer also pays amounts to upgrade the wiring in the buildings so that the retailer can add video monitors and an expanded electronics department. In addition, the retailer removes and replaces the recessed lighting throughout the buildings with more efficient and brighter lighting. The remodeling of the stores results in a material increase in the quality of the stores. Accordingly, the retailer in Example 8 must capitalize amounts paid to remodel the stores, including any costs that directly benefit or are incurred by reason of the remodeling (e.g., amounts paid to replace doors, flooring, and walls). Additionally, amounts paid for the refresh are required to be capitalized because these costs directly benefitted or were incurred by reason of the overall remodeling project.

These three examples illustrate the general rule in the temporary regulations that a determination of whether amounts result in a betterment depends on the facts and circumstances related to the costs.

Restorations

The temporary regulations generally retain the restoration standards provided in the 2008 proposed regulations. The temporary regulations provide that an amount is paid to restore, and therefore improve, a unit of property if it:

- Is for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under Reg. sec. 1.165-7);
- Is for the replacement of a component of a unit of property and the taxpayer had properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- Is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165;
- Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and was no longer functional for its intended use;
- Results in the rebuilding of the unit of property to a like-new condition after the end of its economic useful life; or

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- Is for the replacement of a major component or a substantial structural part of the unit of property.

The temporary regulations generally retain the restoration standards set forth in the 2008 proposed regulations but have revised certain definitions as well as the operating and the application of some of the rules.

Casualty Loss

The temporary regulations retain the casualty loss rule, which requires the capitalization of an amount paid to restore a unit of property if it is for the repair of damage to the unit of property for which the taxpayer had properly taken a basis adjustment as a result of a casualty loss under section 165, or if it is for the repair of damage relating to a casualty event described in section 165. As a result of retaining this rule, the temporary regulations provide taxpayers with the option to forgo claiming a section 165 loss in order to qualify for a section 162 deduction. Specifically, a taxpayer electing to use a general asset account under Reg. section 1.168(i)-1T may forgo recognizing a casualty loss without reducing basis and may claim a repair deduction under section 162 for the replacement property if the replacement cost is not treated as a capital expenditure under a different provision of the temporary regulations.

Rebuilding to a Like-New Condition

The 2008 proposed regulations provided that if an amount paid results in the rebuilding of a unit of property to a like-new condition after the end of its economic useful life, the amount must be capitalized as a restoration of the unit of property. However, an exception provided that if the amount is paid after the economic useful life of the property but during the recovery period (as prescribed in section 168(c)), then the amount is not required to be capitalized. The temporary regulations revise the rule to apply only to amounts paid to rebuild the unit of property after the end of the class life of the unit of property as defined under sections 168(g)(2) and (3). The temporary regulations also remove the recovery period exception so that a taxpayer must look only to the class life of the property in determining the application of this rule.

Replacement of Major Component or Substantial Structural Part

The temporary regulations significantly change the rules in the 2008 proposed regulations for determining whether the costs result in a replacement of a major component or a substantial structural part of a unit of property. The 2008 proposed regulations defined replacement of a major component or substantial structural part to mean either:

1. costs that comprise 50 percent or more of the replacement costs of the unit of property; or
2. replacement of 50 percent or more of the physical structure of the unit of property.



The temporary regulations instead provide a facts and circumstances test for determining whether a major component or substantial structural part is replaced. The temporary regulations also provide that a major component or substantial structural part includes:

1. "a large portion" of the physical structure of the unit of property, or
2. a part or combination of parts that perform a discrete and critical function in the operation of the unit of property that is more than "a minor component."

The temporary regulations contain more examples than the 2008 proposed regulations to illustrate the rules. Included are examples of costs related to the structural components of a roof, roof membrane, HVAC system, fire protection system, electrical system, plumbing system, windows and floors. The examples illustrate that the determination of whether costs are required to be capitalized depends on the nature and extent of the costs relative to the property.

Adaption to a New or Different Use

The temporary regulations maintain the rules provided in the 2008 proposed regulations that taxpayers must capitalize amounts paid to adapt a unit of property to a new or different use. Facts and circumstances will be used to properly determine whether an amount must be capitalized because it is paid to adapt a unit of property to a new or different use.

Dispositions

The temporary regulations include new provisions under section 168 that expand the definition of dispositions to include the retirement of a structural component of a building. This change allows a taxpayer to recognize a loss on the disposition of a structural component of a building before the disposition of the entire building, so that a taxpayer will not have to continue to depreciate amounts allocable to structural components that are no longer in service. Thus, under the temporary regulations, a taxpayer is not required to capitalize and depreciate simultaneously amounts paid for both the removed and the replacement properties.

The temporary regulations provide that the facts and circumstances of each disposition are considered in determining the appropriate asset disposed of. In general, the asset for disposition purposes cannot be larger than the unit of property.

The temporary regulations provide rules for determining the placed-in-service year of the asset disposed of. In general, a taxpayer must use the specific identification method. Under this method, the taxpayer can determine when the asset disposed of was placed in service. If a taxpayer accounts for assets in multiple asset accounts, the IRS and the Treasury Department recognize that it may be impracticable to determine from the taxpayer's records when the asset disposed of was placed in service. Accordingly, the



temporary regulations allow the taxpayer to use a first-in, first-out (FIFO) method under which the taxpayer treats the asset disposed of as being from the multiple asset account with the earliest placed-in-service year that has assets with the same recovery period as the asset disposed of. However, if the taxpayer can readily determine from its records the unadjusted depreciable basis of the asset disposed of, the temporary regulations allow the taxpayer to use a modified FIFO method under which the taxpayer treats the asset disposed of as being from the multiple asset account with the earliest placed-in-service year that has assets with the same recovery period as the asset disposed of and with the same unadjusted depreciable basis of the asset disposed of. If the asset disposed of is a mass asset in a multiple asset account, the temporary regulations also allow the taxpayer to use a mortality dispersion table to identify when the asset was placed in service. Finally, the temporary regulations allow a taxpayer to use any other method designated by the Secretary. However, the IRS and the Treasury Department do not consider a last-in, last-out (LIFO) method to be a reasonable method.

General Asset Accounts

Currently, the depreciation rules generally allow taxpayers to account for their fixed assets individually in a single asset account (SAA), by grouping two or more assets in a multiple asset account (MAA), or by electing to include the asset in a general asset account (GAA). The temporary regulations provide that assets may be grouped into a single MAA or GAA if each asset in the account:

1. Has the same depreciation method (bonus versus non-bonus; listed property versus non-listed)
2. Has the same recovery period
3. Has the same convention (mid-month versus mid-quarter), and
4. Is placed in service in the same taxable year.

Under the general rules for general asset accounts, all proceeds realized on any disposition of property in a general asset account are included in income as ordinary income. The asset, in effect, has a zero basis and no loss is realized. The taxpayer continues to depreciate the general asset account as though no disposition occurred. The taxpayer may elect to recognize gain or loss for a GAA when the taxpayer disposes of all of the assets or the last asset in the account. The temporary regulations retained these rules.

The temporary regulations amend the rule for general asset accounts in regards to qualifying dispositions. Generally, no loss is recognized upon the disposition of an asset from a GAA unless the taxpayer elects to recognize the gain or loss on disposition due to a qualifying disposition. The temporary regulations expand the definition of qualifying dispositions to include the retirement of a structural component of a building. A qualifying disposition also includes a casualty loss, a charitable contribution, termination of a business or income producing activity, and certain types of transactions. Thus, by electing general asset



account treatment, a taxpayer will have the option of recognizing gain or loss on an expanded list of qualifying dispositions.

In order to make the general asset account election, the taxpayer must include a statement at the top of the Form 4562 indicating that this election is being made. The taxpayer must then maintain records detailing the specifics of each general asset account.

Plan of Rehabilitation

The temporary regulations clarify that the “plan of rehabilitation” has been replaced with a section 263A standard for determining which costs must be capitalized once an expense rises to the level of an improvement.

Under the section 263A standard, once it is determined that an improvement exists, all indirect costs that directly benefit or are incurred by reason of the improvement must be capitalized. Thus, for example, if an amount paid results in a betterment of a taxpayer’s plumbing system, all indirect costs that directly benefit or are incurred by reason of that improvement must be capitalized to that improvement.

Routine Maintenance Safe Harbor

The 2008 proposed regulations provided a safe harbor from capitalization for the costs of performing certain routine maintenance activities. Under the safe harbor, an amount paid was deemed not to improve the unit of property if it was for the ongoing activities that a taxpayer (or a lessor) expected to perform as a result of the taxpayer’s (or the lessee’s) use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. The temporary regulations retain this safe harbor with certain modifications. The temporary regulations revise the routine maintenance safe harbor to apply only to property other than buildings.

Acquisition or Production of New Property

The 2008 proposed regulations provided rules for the capitalization of amounts paid to acquire or produce units of tangible property. The temporary regulations retain most of these rules, including the general requirement to capitalize acquisition and production costs, and the requirement to capitalize amounts paid to defend and perfect title to property. The temporary regulations also provide a de minimis rule exclusion as well as rules for the cost of materials and supplies that may be deducted.

Materials and Supplies

The temporary regulations retain the framework of the 2008 proposed regulations for materials and supplies. However, the temporary regulations modify the proposed definition of the first category of materials and supplies by eliminating the requirement that such property not be a unit of property. In the



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first category of materials and supplies, the temporary regulations include components that are acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and are not acquired as part of any single unit of property. Treasury stated that the 2008 proposed rules would not allow many component parts acquired separately from an existing unit of property to be treated as materials and supplies if they were treated as separate units of property. The temporary regulations also add a new category of materials and supplies for fuel, water, lubricants, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations.

In addition to retaining the \$100 de minimis definition of materials and supplies, the temporary regulations allow certain taxpayers to elect to apply the broader de minimis rule under Temp. Reg. Section 1.263(a)-2T(g) to the costs of acquiring or producing any type of material and supply defined in Temp. Reg. Section 1.162-3T if the costs meet the de minimis rule requirements. Alternatively, the temporary regulations retain the rule from the 2008 proposed regulations that allows a taxpayer to elect to capitalize and depreciate amounts paid for certain materials and supplies.

De Minimis Rule

The temporary regulations retain the 2008 proposed regulations' de minimis rule allowing a taxpayer to deduct the amounts paid to acquire or produce property that the taxpayer deducts on its applicable financial statement (AFS) (a defined term). However, the temporary regulations replace the requirement that the deduction not distort the taxpayer's taxable income for the tax year with a bright-line ceiling limiting the total expenses a taxpayer may deduct under the de minimis rule. Under the bright-line, the aggregate of amounts paid and not capitalized under the de minimis rule for the tax year must be less than or equal to the greater of:

1. 0.1% of the taxpayer's gross receipts for the tax year; or
2. 2% of the taxpayer's total depreciation and amortization expense for the tax year on its AFS.

The temporary regulations subject amounts paid for materials and supplies to the de minimis ceiling only if the taxpayer elects under Temp. Reg. Section 1.162-3T to treat those materials or supplies under the de minimis rule of Temp. Reg. Section 1.263(a)-2T. The temporary regulations provide special rules for members of a consolidated group. Taxpayers without an AFS may not use the de minimis rule and must rely instead on Temp. Reg. Section 1.162-3T to deduct materials and supplies that cost \$100 or less.

For more information contact your Dixon Hughes Goodman tax professional or **Jim Fowler** at jim.fowler@dhgllp.com or **704.367.5863**.

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