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IT ALL ADDS UP.

IRS RELEASES EXTENSIVE NEW RULES AFFECTING BUSINESSES THAT ACQUIRE, PRODUCE OR IMPROVE TANGIBLE PROPERTY

The IRS has issued extensive regulations, in temporary and proposed form (the temporary regulations serve as the text for the proposed regulations), providing its long-awaited guidance on the tax treatment of expenditures related to tangible property. These regulations are intended to simplify compliance with Section 263 of the Internal Revenue Code, which generally requires the capitalization of amounts paid to acquire, produce or improve tangible property. They focus largely on how to determine whether expenditures are for deductible repairs or capital improvements. The regulations will affect all businesses that acquire, produce, or improve tangible property.

The new regulations (IRS TD 9564 and REG-168745-03) generally apply to expenditures made in tax years beginning on or after Jan. 1, 2012, so they don't apply to 2011 tax returns. For 2012 and beyond, however, the regulations will affect a wide swath of businesses that purchase, lease, produce or improve tangible property, such as buildings, machinery, vehicles, furniture and equipment.

Background

The new regulations have been in the works for years, and are the IRS's third attempt to provide comprehensive guidance on the issue. After several court cases considered the tax treatment of expenditures related to tangible property, the IRS released in 2006 the first set of proposed regulations, which were withdrawn, modified and re-proposed in 2008. Those proposed regulations never took effect.

The latest regulations provide a general framework for capitalization and retain many of the provisions of the 2008 proposed regulations. In addition, they make some significant revisions, including revisions to certain rules for determining whether a **unit of property** (UOP) has been repaired or improved. For example, much of the guidance in the temporary regulations clarifies the rules for determining the UOP that is being placed in service, repaired, or improved. The smaller the UOP, the more likely it will be that that costs incurred in connection with that UOP will have to be capitalized. The temporary regulations also contain some new rules, as well.

Building Improvements

Perhaps the most widely applicable provisions are those related to building improvements. An improvement occurs if there was a betterment, restoration or adaptation of a UOP.

Under the new regulations, the UOP for a building consists of the building and its structural components. In determining whether an expense is for an improvement to the building, the regulations require the taxpayer to apply the improvement standards separately to the primary components of the building — the building structure *or* any of the specifically defined building systems:

- Heating, ventilation and air conditioning (HVAC) system,
- Plumbing system,
- Electrical system,
- Escalators,
- Elevators,

- Fire protection system,
- Security system,
- Gas distribution system, and
- Any other system identified in published IRS guidance.

A cost is treated as a capital expenditure if it results in an improvement to the building structure or to any of the enumerated building systems. This standard is likely to mean more capitalization, because the regulations make clear that a taxpayer can't, for example, deduct a project such as the replacement of an entire HVAC system.

On the other hand, the regulations include provisions that expand the definition of "dispositions" to include the retirement of a structural component of a building. As a result, a taxpayer can recognize a loss on the disposition of a structural component that occurs before the disposition of the entire building — for example, if you install a new roof and dispose of the previous roof. In other words, the taxpayer doesn't have to continue depreciating amounts allocable to structural components that are no longer in service.

The regulations also incorporate more detailed rules for determining the units of property for condominiums, cooperatives and leased property; for the treatment of leasehold improvements (such as erecting a building on, or making a permanent improvement to, leased property); and for additional costs incurred during an improvement, such as related repair and maintenance costs.

Improvements to Other Tangible Property

The regulations generally define the UOP for real and personal property *other than buildings* to include all "functionally interdependent" components. Components are functionally interdependent if placing one component in service depends on placing the other component in service. The regulations include special rules for plant property and network assets (for example, railroad tracks, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines), as well as a rule for determining the UOP for leased property other than buildings.

The new regulations do not adopt the book life consistency rule that had been contained in the 2008 proposed regulations, which would have required taxpayers to treat a functionally interdependent component as a separate UOP if the taxpayer initially assigned a different economic useful life to the component for financial reporting or regulatory purposes.

The new regulations also provide a safe harbor from capitalization for certain routine maintenance costs for tangible property other than buildings. An activity isn't considered an improvement if the taxpayer expected to perform it as a result of his or her use of the property to keep the property in its ordinarily efficient operating condition. The activity is considered routine if, at the time the property was placed in service, the taxpayer reasonably expected to perform the activity more than once during the property's life.

Characterization of Asset for Depreciation Purposes Overrides UOP Rules in Certain Cases

The new regulations retain the depreciation consistency rule contained in the 2008 proposed regulations, as well as add a second depreciation consistency rule, which override the above UOP rules in certain cases. For property other than buildings, a component of a UOP must be treated as a separate UOP if: 1) the taxpayer properly treated the component as being in a different class of property under the Federal MACRS depreciation system than the MACRS class of the UOP of which the component is a part; or 2) the taxpayer properly depreciated the component using a different depreciation method than the depreciation method for the UOP of which the component is a part. Additionally, if the taxpayer or IRS

properly changes the MACRS class or depreciation method for any type of property (including buildings) in a tax year after the year the property was initially placed in service, then the taxpayer must change the UOP determination for that property to be consistent with such change.

Materials and Supplies

The temporary regulations modify and expand the definition of materials and supplies, which generally can be deducted when used or consumed (rather than capitalized). They define “materials and supplies” as tangible property (other than inventory) used or consumed in the taxpayer’s operations that is:

- A component acquired to maintain, repair or improve a unit of tangible property owned, leased or serviced by the taxpayer and that isn’t acquired as part of any single unit of property; or
- A unit of property that had an economic useful life of 12 months or less, beginning when the property was used or consumed; or
- A unit of property that had an acquisition or production cost of $100 or less; or
- Identified in published IRS guidance as material and supplies falling under such regulations.

Also falling under the definition are fuels, lubricants, water and similar items reasonably expected to be consumed within 12 months.

The regulations also provide an alternative, optional method for accounting for rotable and temporary spare parts. The optional method may be used instead of treating the parts as used or consumed in the year of disposition or electing to treat the parts as depreciable assets.

De Minimis Rule for Expensing

The regulations include an exception to capitalization for certain acquisitions. If a taxpayer expenses the purchase price of tangible property for financial reporting purposes, following written accounting procedures for expensing those amounts, the taxpayer can now deduct the amount for tax purposes, up to a threshold.

The aggregate amount paid and not capitalized must be less than or equal to the greater of 0.1% of the gross receipts for the tax year for income tax purposes or 2% of the total depreciation and amortization expense for the tax year (as determined in its applicable financial statement).

The de minimis rule also applies to the purchase of certain categories of materials and supplies. Previously, a taxpayer generally couldn’t deduct these expenditures until the goods were used or consumed.

Moving Forward

If you have expenditures related to tangible property, the temporary regulations apply to you. Compliance with these comprehensive and complex new rules may require changes to your current capitalization procedures. Any such changes likely will require the filing of Form 3115, “Application for Change in Accounting Method”, to obtain the necessary IRS consent. Please contact us if you have questions regarding the new regulations and how to best proceed.