## Capital Expenditure or Deductible Repair? IRS Finally Has Answers

After seven years of drafts and proposed regulations, the IRS has issued final regulations on the question of whether an expenditure relating to tangible property is a deductible repair or a capital expenditure.

“These new regulations give guidance on difficult questions, such as whether replacing a building component for $200,000 is a current deduction or depreciable over 39 years,” says Jim Andreucci, a manufacturing and distribution tax principal. “There are few bright line tests, but there’s more definition than we have had in the past. And in some cases, past transactions may need current adjustment under these regulations.”

In the case of any prior expenditures that may need adjustment under these regulations, corrections can be made under favorable accounting method change procedures for the 2014 tax year. But some businesses will need to adopt new written accounting policies before January 1, 2014.

### Amounts paid to acquire or produce tangible property

In general, the regulations distinguish between amounts paid to acquire or produce tangible property and amounts paid to improve existing property. A taxpayer must always capitalize amounts paid to acquire or produce tangible property unless the property:

1. Qualifies as materials and supplies, or
2. qualifies under the de minimis safe harbor and conforms to the taxpayer’s safe harbor election.

For improvements to property, capitalization is required if the expenditure is a betterment, restoration, or adaptation of the unit of property.

#### *Materials and supplies*

Incidental materials and supplies may be deducted when purchased. These are items for which no record of consumption is kept and expensing the items does not distort income. Materials and supplies that do not fit these definitions are deducted when used or consumed.

A deductible material or supply is tangible personal property, other than inventory, used or consumed in the taxpayer’s operations. This includes fuel, lubricants, water, or similar items reasonably expected to be consumed in 12 months or less. It also includes:

- Other property with an economic useful life of 12 months or less
- An item with an acquisition or production cost of $200 or less
- A component acquired to maintain, repair, or improve a unit of tangible property that is not acquired as part of a single unit of property

***Rotable and temporary spare parts***

This category is a subset of materials and supplies. Taxpayers are allowed several alternative methods, with the third choice a new option in these regulations:

1. Deduct the cost of these parts only when they are disposed of,
2. capitalize and depreciate the spare parts, or
3. deduct the cost of the spare part when first installed, but record income at its fair market value when removed, and continue that process until claiming a final loss at disposition.

### De minimis safe harbor election

A taxpayer may elect a de minimis safe harbor to deduct the amounts paid to acquire or produce tangible property up to a dollar threshold. That limit is $5,000 per invoice (or per item in the case of a taxpayer with an Applicable Financial Statement (AFS)), but only $500 for those without. An AFS is one of three types of financial statements:

1. A 10-K filed with the SEC,
2. a certified audited financial statement prepared by an independent CPA, or
3. a financial statement required for a federal or state governmental entity.

The expenditure must always be treated as a deduction in the AFS to qualify for the safe harbor.

In order for a taxpayer to use the de minimis safe harbor, there must be a written accounting procedure in place at the beginning of the tax year. In order for calendar year taxpayers to use this provision, there must be a written policy in place by January 1, 2014.

Finally, the de minimis privilege requires an annual election in a timely filed tax return.

*Example:* Alpha Company, a small business, purchases 10 laptops at $300 each for a total cost of $3,000 per the invoice. Alpha does not have an AFS, but has adopted a written accounting procedure to expense amounts paid for property costing less than $500. The amount paid for each laptop meets the de minimis safe harbor, and Alpha may deduct the expenditure as a business expense.

*Example:* Beta Corporation is a member of a consolidated group for federal tax purposes and is part of a consolidated AFS. Beta acquires 200 computers at $4,000 each for the current year. Beta has a written accounting procedure in place to expense amounts paid for property costing $5,000 or less. Beta may deduct the purchase of the computers as an ordinary business expense.

## Amounts paid to improve property

In general, a taxpayer must capitalize amounts paid to improve a unit of property. The regulations define three types of expenditures that must be capitalized:

1. A betterment,
2. a restoration, or
3. an adaptation to a new or different use.

The starting point in this regime is to define the unit of property that is the subject of the improvement. In general, the larger the unit of property, the greater the likelihood that the expenditure will not be viewed as a capitalized improvement. A unit of property is defined as all components that are functionally interdependent. For example, a computer and printer, even though purchased together, are not functionally interdependent, as placing one asset in service is not dependent on placing the other asset in service.

For buildings, the regulations identify eight separate building systems that are considered separate units of property from the building structure (e.g., HVAC systems, plumbing systems, electrical systems, escalators). As a result, when replacing components of one of these systems, it will be more difficult to take the position that a deductible repair expenditure has occurred.

### *Betterments*

Betterments include expenditures that:

1. Materially improve the productivity, strength, quality, or output of the unit of property,
2. represent a material addition to the asset, such as a physical enlargement or an increase in the property's capacity, or
3. correct a material condition or defect that existed prior to acquisition or that arose during production of the property.

### *Restoration*

A restoration must be capitalized if it is replacing a component on which the taxpayer recognized a gain or loss on disposition. Also, this definition extends to restoring property to operational status if it has not been functional, or rebuilding property to a like-new condition after the end of its class life in the tax system (the class life is generally longer than the depreciable life). It also includes replacing a major component or substantial structural part of the unit of property.

### *Adaptations*

An amount must be capitalized if it is paid to adapt a unit of property to a new or different use.

“These three terms — betterment, restoration, and adaptation — are key definitions within the new regulations,” says Andreucci. “The definitions are somewhat subjective, but thankfully, the regulations come with a great number of examples. In one illustration, replacing 30 percent of the wiring of a building is not a restoration requiring capitalization, but in another, replacing 40 percent of the flooring is a significant restoration that must be capitalized.”

### Small taxpayer building safe harbor

The regulations provide a new safe harbor deduction for small taxpayers for amounts paid for improvements and repairs to an eligible building. A small taxpayer is one whose average annual gross receipts, measured for the prior three years, is less than $10 million. An eligible building is one with a tax basis, before depreciation, of $1 million or less. Assuming these two criteria are met, the business can deduct the smaller of $10,000 or 2 percent of the cost of the building annually. This election is accomplished by attaching a statement to a timely filed tax return.

*Example:* Delta Company is a small business with average annual gross receipts under $10 million. It uses two buildings in its business, each with an original cost plus improvements of less than $1 million. For each building, Delta qualifies for the safe harbor. If one building has a pre-depreciation tax basis of $600,000, Delta may deduct up to $10,000 per year of improvements or repairs by making this election (lesser of $10,000 or 2 percent of building’s unadjusted basis [2 percent x $600,000 = $12,000]). If the other building has a tax basis of $450,000, the annual limit for that building is $9,000 (2 percent of $450,000, which is less than $10,000). If the amounts paid for repairs and improvements exceed the annual limit for a building, the safe harbor is not available for that year.

### Dispositions

A portion of the new regulations, issued in proposed status, allows a taxpayer to claim a loss when disposing of a portion of an asset. For example, if a taxpayer removes an old roof, the taxpayer may identify the undepreciated basis of the building attributable to the old roof, using any reasonable method, and claim a disposition loss. In addition, the removal costs are added to the disposition loss. But if this loss treatment is elected, the replacement asset must be capitalized.

A special rule protects taxpayers who do not claim a disposition loss and instead claim a repair deduction for an improvement. If the IRS later capitalizes the repair expenditure, the taxpayer may file an accounting method change to claim the partial disposition loss.

“In the past, the concepts of claiming a partial disposition loss and deducting removal costs were not part of our tax system,” observes Andreucci. “This gives valuable new flexibility, and will allow some costs now on depreciation schedules to be written off.”

## Accounting method changes

The IRS has indicated it will be issuing separate revenue procedures to allow taxpayers to make automatic consent accounting method changes to comply with the new regulations. The regulations are generally effective for tax years beginning on and after January 1, 2014. Accordingly, the IRS cannot impose changes under these regulations until examining the 2014 tax year. At the earliest, these exams would occur in late 2015, and for most taxpayers, not until 2016.

If the taxpayer submits an accounting method change form prior to notification of any IRS exam, a favorable adjustment regime applies. If a previously deducted item is voluntarily capitalized by the taxpayer, the income amount is spread forward equally over four tax years (the current year plus the next three). On the other hand, if a loss is claimed, such as to correct for a prior partial disposition, an immediate deduction is allowed.

"Buildings, major machinery, and other property on taxpayer depreciation schedules in 2014 will become fair game for the IRS under the new regulations," notes Andreucci. "Businesses will want to carefully review the new definitions, and determine if opportunities or exposures are present. If so, using accounting method change procedures is the efficient solution."

## How we can help

The new regulations are voluminous and contain many examples. They are best applied by first having an understanding of a taxpayer's situation with respect to real estate, machinery, and other property, as well as the types of repair expenditures typically incurred. The principles of the regulations can then be applied. Many taxpayers will want to adopt a written de minimis accounting policy before the beginning of their 2014 tax year.