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# *Tax Insights*



## **New temporary and proposed regulations on tangible property capitalization significantly depart from prior proposed regulations**

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## Treasury and the IRS have issued a comprehensive guidance package containing temporary (T.D. 9564) and proposed (REG. 168745-03) regulations on the application of Section 263(a) to amounts paid to acquire, produce or improve tangible property.

T.D. 9564 also provides some bright line tests (e.g., a de minimis rule for certain acquisitions) for applying the standards and provides a definition of materials and supplies under Reg. Section 1.162-3. In addition, the temporary regulations contain guidance on accounting for, and dispositions of, property subject to Section 168. The temporary regulations make some major changes from the prior 2008 proposed regulations (see Tax Alert 2008-379).

T.D. 9564 applies to tax years beginning on or after January 1, 2012, although some portions of the regulations apply to amounts paid or incurred in tax years beginning on or after January 1, 2012. Transition rules that provide procedural guidance are anticipated to be published in revenue procedures during January. The forthcoming transition rules are anticipated to require a Section 481(a) adjustment (and, correlatively, the filing of Form 3115, Application for Change in Accounting Method) for certain changes in treatment that will be required, presumably with a waiver of method change eligibility/scope provisions applicable to taxpayers under IRS examination.

T.D. 9564 withdraws the 2008 proposed regulations. The text of the temporary regulations also serves as the text of the new proposed regulations.

Additional Tax Alerts will be issued elaborating further on this significant regulation package and related forthcoming guidance. This Tax Alert provides a summary of the major provisions of the regulation package.

### Temporary regulations

#### 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. The temporary regulations include in the first category of materials and supplies 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, the temporary regulations continue the proposed general rule that taxpayers must dispose of rotatable spare parts to claim a deduction or alternatively may elect to treat the parts as depreciable assets. However, the temporary regulations also offer an optional accounting method based on a commentator's feedback regarding the treatment many taxpayers currently use for rotatables. If the optional method is adopted, it must be used for all of the taxpayer's rotatable and temporary spare parts in the same trade or business.

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.

## Amounts paid to acquire or produce tangible property

Subject to the non-incidentals supplies provisions and a de minimis rule (the latter of which is discussed below), the temporary regulations provide that amounts paid to acquire or produce tangible property must be capitalized and amounts paid to defend or perfect title to tangible property must be capitalized. In addition, the temporary regulations require capitalization of amounts paid to facilitate the acquisition or production of real or tangible personal property, including a list of inherently facilitative amounts and a special “whether and which” test for the acquisition of real property. The temporary regulations clarify that a taxpayer may be required to allocate some facilitative costs between personal and real property acquired in a single transaction. Thus, the temporary regulations add a reasonable allocation rule to assist taxpayers in making allocations of facilitative costs between personal and real property.

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 ceiling, 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.
- 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.

## Amounts paid to improve tangible property

### Definition of “unit of property”

Although the temporary regulations retain the general rule that a building and its structural components are a single unit of property, the regulations effectively break the building into some component parts for purposes of applying the improvement standards separately to the specifically defined building systems (i.e., heating, ventilation and air conditioning (HVAC); plumbing systems; electrical systems; all escalators; all elevators; fire-protection and alarm systems; building security systems; the gas distribution system; and other structural components identified in yet-to-be-published guidance). The remaining building structure is treated as one unit of property (and includes, for example, the roof, walls, foundation, doors, windows and general finishes, such as flooring

and ceiling). If an amount paid results in a restoration or betterment of the building structure or a building system, the expenditure is an improvement to the building unit of property.

For leased buildings, the temporary regulations provide that if a taxpayer is a lessee of all or a portion of one or more buildings, the unit of property is each building and its structural components or the portion of each building subject to the lease and the structural components associated with the leased portion. An amount is paid for an improvement to a leased building or a leased portion of a building if the amount paid results in an improvement to the leased building structure or building systems.

The temporary regulations retain the 2008 proposed regulations’ rule that a leasehold improvement that is Section 1250 property and is constructed by a lessee is a separate unit of property. The temporary regulations extend that rule to Section 1245 property.

For other tangible property, the temporary regulations generally define a unit of property using a functional interdependence test. That is, all components that are functionally interdependent (if the placing in service of one component by the taxpayer depends on the placing in service of the other component by the taxpayer) comprise a single unit of property. A special rule for plant property results in a smaller unit of property if it is determined that a component or group of components performed a discrete and major function or operation within the functionally interdependent machinery or equipment. What constitutes “discrete and major” is not defined under the proposed rules. Plant property is

functionally interdependent machinery or equipment, other than “network assets” (defined below) that perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries or other similar activities.

A component of a unit of property must be treated as separate if the taxpayer has properly (1) treated the component as a different class of property under Section 168(e) than the unit of property to which the component belongs or (2) depreciated the component using a method that differs from the one used for the unit of property to which the component belongs.

Thus, qualified leasehold improvement property is a separate unit of property from the rest of a building because it has a different depreciation recovery period.

The temporary regulations do not contain the proposed rule requiring taxpayers to treat a functionally interdependent component as a separate unit of property if the taxpayer initially assigned a different economic useful life to the component for financial statement or regulatory purposes.

For network assets, the unit of property is determined by the taxpayer’s particular facts and circumstances, except as provided in published guidance; the functional interdependence standard is not determinative. Earlier this year, the IRS previously issued guidance defining units of property for the telecommunications industry and for electric transmission and distribution assets. (See Tax Alerts 2011-641 and 2011-1402.) Under the currently proposed regulations, network assets means railroad track, oil and gas pipelines, water and sewage pipelines,

power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in those respective industries.

#### **Plan of rehabilitation**

The temporary regulations officially make the plan-of-rehabilitation doctrine obsolete to the extent the doctrine provided different standards than Section 263A for determining whether an otherwise deductible indirect cost must be capitalized as part of an improvement. The temporary regulations clarify that all indirect costs, including repair and removal costs, are subject to the Section 263A standard and must be capitalized as part of an improvement to the extent the costs are incurred by reason of the improvement.

#### **Betterment or restoration of property**

Under the temporary regulations, an amount paid results in a betterment only if it (1) corrects a material defect existing prior to acquisition or during production of the property; (2) results in a material addition; or (3) results in a material increase in capacity.

The temporary regulations do not provide bright-line tests for assessing these standards. Instead, these determinations are based on a taxpayer’s particular facts and circumstances, taking into account, for example, the purpose of the expenditure, the nature of the work performed, the effect of the expenditure on the unit of property and the treatment of the expenditure on the taxpayer’s AFS.

The temporary regulations also require capitalization of amounts paid to restore a unit of property. For these purposes, restoration would include, among other items:

- ▶ Returning a property to its ordinarily efficient condition from a state of nonfunctional disrepair
- ▶ Rebuilding the property after the end of the class life of the unit of property, as defined in Section 168(g)(2) and (3)
- ▶ Replacing a major component or substantial structural part of the property
- ▶ Repairing damage to a unit of property relating to a casualty event described in Section 165

The new rules eliminate the formerly proposed bright-line definition for a major component or substantial structural part of the unit of property. The prior rule defined this term as including the replacement of a part or combination of parts of the unit of property, the cost of which is 50% or more of the replacement cost of the unit of property or the replacement of a part or combination of parts of a unit of property that makes up 50% or more of the physical structure of the unit of property. Rather than a bright-line definition, the temporary regulations rely on “all the facts and circumstances,” which include the “quantitative and qualitative significance” of the part or combination of parts in relation to the unit of property.

Although the IRS received numerous comments requesting removal of the casualty loss, the IRS explained in the preamble to the temporary regulations that it retained that rule because it is “consistent with the fundamental principle that a taxpayer must capitalize the cost of acquiring new property.” However, the IRS noted that a taxpayer’s remaining basis in property damaged in a casualty event may be insignificant compared to the costs necessary to restore the property. Accordingly, it revised the rules

of accounting for property to which Section 168 applies (MACRS property) and for determining gain or loss on the disposition of MACRS property. Under those rules, a taxpayer may elect to use a general asset account under Temp. Reg. Section 1.168(i)-1T and forgo recognizing a casualty loss (without reducing basis) and claim a repair deduction under Section 162 for the replacement property, provided the replacement cost is not treated as a capital expenditure under a different provision of the temporary regulations.

The temporary regulations also add new examples to illustrate the application of these rules.

#### **Routine maintenance safe harbor**

The temporary regulations retain the routine maintenance safe harbor of the 2008 proposed regulations, but only for tangible personal property. Under the safe harbor, an amount paid is deemed to not improve the unit of property if it is for the ongoing activities that a taxpayer (or a lessor) expects to perform as a result of the taxpayer's (or a lessee's) use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Activities are considered routine only if, at the time the taxpayer places the unit of property in service, it reasonably expects to perform the activities more than once during the class life of the unit of property. Similar to the 2008 proposed regulations, the safe harbor contains exceptions that require taxpayers to run through many of the general restoration rules prior to determining whether the activities meet the safe harbor.

#### **Accounting and disposition rules for MACRS property**

T.D. 9564 revises the rules for accounting for assets to which Section 168 applies and the rules for determining gain or loss on the disposition of MACRS property. Specifically, the temporary regulations eliminate group accounts, classified accounts and composite accounts and provide that each multiple asset account must include, in most cases, assets with the same depreciation method, recovery period and convention, and be placed in service in the same tax year. The temporary regulations also provide rules for determining gain or loss on the disposition of MACRS property that are consistent with the disposition rules under Reg. Section 1.168-6 of the proposed MACRS regulations. Importantly, the temporary regulations expand the definition of disposition for MACRS property to include retirement of a structural component of a building. The new rules also outline certain circumstances in which a taxpayer may recognize a loss on a retirement of a building component, for example, with the result that a related replacement expenditure be capitalized and depreciated.

#### **General asset accounts**

The temporary regulations amend the rules for general asset accounts under Reg. Section 1.168(i)-1 by expanding the definition of disposition to include the retirement of a structural component of a building. The temporary regulations also expand the definition of a qualifying disposition to allow the recognition of gain or loss on most dispositions of assets in general asset accounts. Additionally, the temporary regulations modify the rules for establishing general asset

accounts and clarify the depreciation calculation for a general asset account when the assets in the account are eligible for the additional first-year depreciation deduction.

## **Implications**

The newly issued regulations contain many broad-reaching rules that go way beyond repairs. As stated in the preamble, the regulations will affect all taxpayers that acquire, produce or improve tangible property.

The temporary regulations contain significant modifications from the prior 2008 proposed rules. Some changes provide much needed clarification. For example, the revisions to the materials and supplies definition to include certain liquid supplies and to allow the use of the broader de minimis rule are welcome revisions.

However, in some instances, the temporary regulations make revisions that are anticipated to increase administrative burden and, in many situations, to be a continued source of controversy. For example, establishing an official de minimis rule may resolve controversy for many taxpayers that have been barred from using one on IRS exam. However, the modification to the de minimis rule to require capitalization of all amounts above the bright-line ceiling will cause much administrative difficulty for taxpayers that have come to agreements with IRS exam teams. The 2008 proposed regulations provided taxpayers and their local IRS exam teams the flexibility to come to agreements on whether certain amounts over a proposed safe harbor distorted income (or whether such amounts were material enough to even be examined). These taxpayers

are not currently tracking such amounts for book or tax purposes. Because the temporary regulations create a bright-line rule rather than a safe harbor, it removes taxpayers' and IRS exams' flexibility in determining whether the amounts must be capitalized and depreciated to conform to the regulations.

Additionally, other safe harbors proposed by the 2008 regulations were eliminated and require taxpayers to rely on facts-and-circumstances tests that are not easily administrable and will likely be a continued source of controversy. For example, the change to a facts-and-circumstances determination of a "major component" of the unit of property does not provide the clarity of the prior proposed bright-line rule, particularly because the regulations do not provide insight into which facts and circumstances control. The examples do not contain enough facts and analysis to determine which factors are considered most important or how to determine whether a component is "major."

The temporary regulations generally apply to tax years beginning on or after January 1, 2012. Thus, taxpayers must begin complying with the new rules at that time. However, we anticipate considerable public dialogue regarding the temporary rules and proposals for modification from affected taxpayers, industry representatives and other commentators.

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