Understanding the Final 2013 Regulations for Tangible Property for Commercial Buildings

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New IRS Guidance

For Taxable Years Beginning on or after Jan. 1, 2014

- Addresses a broad range of capitalization and deduction issues for expenditures related to tangible property;
- Taxpayers may make certain elections on amended returns for taxable years 2012 and 2013
- Treatment of materials and supplies;
- Capitalization of amounts paid to acquire or produce (or facilitate the acquisition or production of) tangible property;
- The determination of whether an expenditure with respect to tangible property is a deductible repair or must be capitalized;
- Dispositions of Modified Accelerated Cost Recovery System ("MACRS") property.

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The 2013 Regulations retain many of the provisions included in the temporary regulations issued in 2011 ("2011 Temporary Regulations"); however, there are a number of new provisions and changes from the 2011 Temporary Regulations as well as changes to pre-January 1, 2014 law. The major changes include:

- The 2011 Temporary Regs specifically excluded buildings
- A De minimis safe harbor election
- Small taxpayer safe harbor election
- Addition of a casualty loss rule to the restoration rules
- Expansion of the routine maintenance safe harbor to include repairs to buildings (and structural components thereof) and building systems
- Capitalization election
- Revisions to the disposition rules, including partial disposition election (Revised Aug. 2014)
- Changes to the general asset account rules to account for the new disposition provisions

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Repairs – Treasury Reg. 1.162-4

Amounts paid for repairs and maintenance to tangible property are deductible if the amounts paid are not required to be capitalized under Reg. 1.263(a)

- Final regulations establish rules for determining whether an amount improves, betters, or restores property.
- New Standards : Substantial authority to expense v. capitalize
  - Strictly limits items that can be expensed
- New rules to determine when a taxpayer may claim loss deductions on asset replacement
- Allow for loss recovery on disposition of MACRS building structural components in lieu of double depreciation (e.g. roof replacement write off of old roof as a loss)

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Materials & Supplies -

Tangible property used or consumed in the taxpayer's operations that is not inventory and is:

- A component acquired to maintain, repair, or improve a unit of tangible property (includes rotable and temporary spare parts);

- Fuel, lubricants, water, or similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in taxpayer's operations (new category);

- A unit of property that has an economic useful life of 12 months or less;

- A unit of property with an acquisition or production cost of $200 or less;

or

- Property identified in published guidance.

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Unit of Property - UOP

- Before 2013 –
  - UOP was the building and its structural components
  - Capitalize v. repair was determined by impact on the UOP as a whole
- Sec. 263(a) makes expensing a lot more difficult

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Unit of Property – New Rules

UOP is now:

1. Building & Structural Components
2. Building Systems

- Building & Structural Components
  - Walls /Wall Partitions
  - Windows
  - Roofs
  - Stairs
  - Doors
  - Fire Escapes
  - Floors & Ceilings
  - Permanent Coverings (Paneling, Tiling)
  - Other Components relating to operation/maintenance

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Unit of Property – New Rules

UOP is now:

1. Building & Structural Components
2. Building Systems

- Building Systems
  - HVAC System
  - Plumbing System
  - Electrical System
  - Escaltors
  - Elevators
  - Fire Protection/Alarm Systems/Security Systems
  - Gas Distribution Systems
  - Land Improvements
  - Other Systems in published guidance

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Change in Accounting Method

- IRS Rev. Proc. 2011-14, 2014–16, 2014-17, 2014-54 for Automatic Consent
- Includes a change, if any, in the method of identifying the unit of property, or in the case of a building, identifying the building structure or building systems for the purpose of making this change.
- If Change in Materials/Supplies Treatment
- For Change in applying DeMinimis Rules
- Requires Timely File IRS Form 3115 to Comply Effective Jan. 1, 2014 (Or in year of change)
- May Require Filing of 2-3 Form 3115
- See Internal Revenue Bulletin: 2014-9

Substantial Authority to Expense Structural Components Demo/Disposal

- Changes related to dispositions under Final Regs
- Limited Window to "Look-back" at prior dispositions
- Extends late partial disposition election through 2014 – Must File Timely Form 3115 with "Late Partial Disposition Election" *<u>for 2014 Returns Only</u>*
- Remove cost of demo/disposal of old component from cost basis of building and recognize loss on abandonment
  - Cost Segregation Study Captures Cost
  - Other Reasonable Cost Estimation allowed
    - Producer Price Index

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Substantial Authority to Expense Structural Components Demo/Disposal

- 2014 is Last Year to write-off remaining cost basis of retirements from prior years by Automatic Consent
- Auto dealerships, retailers, restaurants, manufacturers, office, apartments, others who are currently "double depreciating" after improvements
- For prior roof replacement/repair, HVAC, lighting, windows, plumbing, painting
- Look back for 2013 and 2012 for sure, possibly further – Awaiting IRS guidance

Retirements – Permanent Tax Savings

- Capitalized and depreciated assets that are retired will have recapture tax upon sale
  1) Sec. 1245 Assets Recapture Tax at Ordinary Rates (35%, 39.6%)
  2) Sec. 1250 Assets Recapture Tax at 25%
  3) Capital Gains Currently 20%

- Retirement "Study" results in $0 Recapture Tax

- Taxpayer pays L-T Capital Gain tax at 20%
- Difference is Permanent Tax Savings

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Removal Costs - Demolition

- Old Rules – Capitalize Demo Costs with new improvements
- New Rules – Removal Costs can be ducted if taxpayer retires old component for tax purposes

- Expense Demo costs and expense remaining tax basis of building assets demolished/disposed of
- Cost Basis of components removed determined with Cost Segregation Study, IRS-approved estimating, PPI
- IRS Restricts use of Discount Value Approach

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Amounts Paid to Produce or Acquire Tangible Property

- Amounts paid to acquire or produce tangible property or to defend or perfect title to such property must be capitalized
  - In addition, a taxpayer must capitalize amounts paid to facilitate the acquisition or production of tangible property
  - Inherently facilitative activities similar to the list in Treas. Reg. § 1.263(a)-5, and include, among other costs, bidding costs; finders' fees or brokers' commissions; and costs of securing an appraisal.
  - Non-inherently facilitative pre-decisional investigatory costs paid in pursuing the acquisition *of real property* are not considered facilitative, and therefore are not required to be capitalized (deductible)

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Routine Maintenance Safe Harbor

Exception to Capitalization Rule

- 2011 Temporary Regs specifically <u>excluded</u> buildings
- Safe harbor applies to routine and recurring activities that, as of the date the UOP is placed in service, a taxpayer reasonably expects to perform more than once during the UOP's alternative depreciation system ("ADS") class life as a result of a taxpayer's use of the property.
- The safe harbor is applicable to a building, structural components of buildings, and building systems, but the taxpayer must reasonably expect to perform the activities more than once during the 10-year period beginning with the placed in service date of the building, structural component, or building system.
- Not routine if results in betterment or adaptation

Small Taxpayer Safe Harbor Election

- A taxpayer with average annual gross receipts of $10 million or less can expense repairs, maintenance, and improvements that are made with respect to an owned or leased eligible building property, and the total cost of which for the tax year is lesser of 2% of basis, or $10,000 per building
- An eligible building property is a building with an unadjusted basis of $1 million or less
- The unadjusted basis of a leased building is determined based on the total rents to be paid over the lease term (taking into account reasonably expected renewals)
- If amount >$10K, Safe Harbor disallowed for all

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DeMinimis Safe Harbor Election

- An eligible taxpayer may generally deduct amounts paid for property, where the per item or per invoice amount does not exceed $5,000. An eligible taxpayer is a taxpayer that
  1) has an Applicable Financial Statement (AFS)
  2) has a written capitalization policy as of the first day of the tax year to expense amounts paid for tangible property costing less than a certain dollar amount or having a useful life of 12 months or less, and
  3) expenses amounts on its AFS consistent with the written policy.

- Can be made at the consolidated group level.

- Taxpayers without AFS – Threshold reduced to $500

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DeMinimis Safe Harbor Election

- What if taxpayer is without AFS?
  - DeMinimis election can be made if written policies and procedures
  - Deminimis if less than $500 per item or invoice
    - Includes machinery & equipment purchased in bulk as long as per item price is less than $500

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Plant Property

Plant property is "functionally interdependent machinery or equipment, other than network assets, used to perform an <u>industrial process</u>, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or similar activities."

- **The UOP for plant property is initially determined based on the functional interdependence standard.**
- **Functionally interdependent plant property is further divided into smaller UOPs based on a component or a group of components that perform a discrete and major function or operation.**
- **Same treatment as 2011 Temporary Regulations**

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Leased Property

- Applies the general rule for determining the UOP and improvements
- Lessor – If multi-tenant, UOP is always the entire building. Individual building systems are each a UOP (hvac, elec., etc)
- The UOP is each building and its structural components associated with the leased portion of the building.
- Taxpayer-lessee must apply the improvement standards (as discussed below) to the leased building or leased portion of the building and the related building systems
- Lessee improvements made to a unit of leased property is a separate UOP.
- Retrofit with energy efficient lighting by either is likely capital

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Improvement Standards

Must Capitalize Amounts Paid that result in a:

- Betterment of a UOP
- Adaptation of UOP to a new or different use
- Restoration of a UOP

- Based on Facts and Circumstances
- Improvement standards are now applied at the smaller scale of the building v. building systems.
  - Must Analyze each cost in context of Unit of Property
- Cost Seg components are separate UOP for 5, 7, 15 year MACRS Property
- Limits what can be expensed as a repair
  - Major Portion of UOP is Capital Improvement

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Betterments of UOP

- Facts and Circumstances still determine if improvement
- Corrects a material condition or defect - Must Be Capitalized (all direct and indirect costs)
- Material condition or defect that existed prior to acquisition is a betterment (whether taxpayer had knowledge or not).
- Results in a material addition, expansion to UOP
- Results in a material increase in capacity, productivity, efficiency, or quality of the UOP
- A cosmetic refresh/remodel of retail stores is not a betterment if no material addition, capacity, etc.

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Betterments of UOP

- Spot Asbestos Abatement – Not a Betterment
- Reconfigure office space to add employees, capacity, workload by install of workstations, electrical, voice/data is a betterment
- Removal of contaminated soil is a betterment
- Full tear-off and re-roof if roof 40 years old is betterment
- Repairs to roof that are "routine" are not a betterment
- Expenditures to a "Substantial Structural Part" are a betterment

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Adaptation of UOP

- New or different use UOP Must Be Capitalized (all direct and indirect costs)
- What was intended ordinary use v. new use
- Change in use includes from Manufacturing to retail showroom, warehouse to loft apartments
- Expenditures to cosmetic improve of interior/exterior for purposes of sale are not change in use. Expense these improvements.

Restoration of UOP

Must Capitalize

- **IRC Sec. 263(a) defines a restoration as an expenditure if:**
- It returns the UOP to its ordinary efficient operating condition if the property had deteriorated to a state of disrepair and no longer functional
- It results in the rebuild of the UOP to a like-new condition after the end of its class life
- It replaces a part or combination of parts that comprise a major component or substantial structural part of the UOP
- Repairing damage to a UOP for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss
- e.g. replacement of 100% of all sinks and toilets (major component of plumbing system UOP) must be capitalized

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Restoration of UOP

- Substantial Structural Part – Large physical portion of building or building system is Capital
  - Replacement of all HVAC Chillers/Cooling Towers
  - Replacement of 1 of 4 Chillers as Repair Expense
- Replacement of minor component of UOP is not capital even if it affects the function of the UOP
  - Example – Replacement of HVAC Thermostats
  - Example – Interior office lighting may be a minor portion of electrical system
- Replacement of windows can be "minor component" of building envelope – Not a Restoration

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Restoration of UOP

Office Building HVAC Rooftop Condenser Example

- HVAC System(with thermostats, controls, ducts) is the UOP
- Building owner replaces 3 of 10 rooftop condensers that are failing
- All 10 Condensers alone are a major component or substantial structural part of the UOP
- Replacement of 3 condensers are not a major component of UOP). Does not require to be capitalized
- Taxpayer may make a capitalization election

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Resources

- IRS.gov
- Journal of Accountancy. Implementing the NewTangible Property Regulations. http://www.journalofaccountancy.com/Issues/2014/Feb/20137725.htm
- Tax Clinic: Tangible Property Regulations", May 2012