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New Repair Regulations and Necessary Elections

On December 23, 2011, the IRS issued comprehensive guidance regarding amounts paid to acquire, produce or improve tangible property and what can be expensed as repairs and maintenance or materials and supplies. These regulations are commonly referred to as the “repair regs” and are extremely lengthy (approximately 250 pages) and complex. On November 20, 2012, the IRS subsequently issued Rev. Proc. 2012-73 which delayed the mandatory implementation date of the repair regs to tax years beginning on or after January 1, 2014. Early implementation is allowed for tax years beginning on or after January 1, 2012. These regulations impact three IRS code sections:

1. §263(a)-Acquisitions and improvements
2. §162-Materials and supplies
3. §168-General accounts and MACRS dispositions.

The IRS has emphasized that three provisions of the regulations will likely change before finalization of the temporary regs sometime in 2013. These provisions are the de minimis expensing rule, dispositions and the routine maintenance safe harbor.

The temporary regulations (“regs”) redefined a unit of property as it relates to an improvement. A building is still a unit of property (“UoP”), as under prior regulations. However, the regs also define nine building systems that are now considered a UoP when determining if an expenditure is a capital expenditure or a repair. A major repair to not only the building itself, but one of these systems or a structural component of the building (such as a roof), is considered an improvement and must be capitalized.

The nine building systems are:

1. HVAC
2. Plumbing
3. Electrical
4. Escalators
5. Elevators
6. Fire protection and alarm
7. Security
8. Gas distributions
9. Other systems and components identified in published guidance.

Under the regs, there are three types of improvements: 1) A betterment; 2). A restoration and 3). An adaption to a new or different use. As stated previously, any expenditure falling into one of these categories must be capitalized.

Materials and supplies are defined in the regs as tangible property used or consumed in the taxpayer's business that is not inventory and falls into any of the following categories:

- A component acquired to maintain, repair or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property
- Fuels, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less
- It is a UoP with an economic life of 12 months or less
- It is a UoP with acquisition or production cost of $100 or less
- Other property identified as materials and supplies in published IRS guidance

Taxpayers with an applicable financial statement ("AFS") or a certified audited financial statement accompanied by an independent CPA's report used for credit or reporting purposes have a special de minimis expensing rule. These taxpayers can follow the book treatment if written accounting procedures are in place for expensing amounts paid under a certain dollar amount. There are overall limits of the total expense that can be deducted for tax purposes (the greater of .1% of gross receipts or 2% of total depreciation and amortization). For small taxpayers without any type of audited financial statement, any expenditure over $100 must be capitalized.

Dispositions

One of the most controversial, yet taxpayer friendly, changes in the regs is the treatment of dispositions. A loss on disposition must be calculated and recognized on every building component removed from a building or building system. In addition, the restoration rules require that if a loss has been taken, the replacement must be capitalized: Taxpayers cannot take both a loss on disposition and a repair deduction. Casualty losses are treated the same as dispositions under the regs. Since the taxpayer recognized a loss, any repairs or replacements must be capitalized as these are made to restore the property.

The advantage of the new regs is that, unlike the prior regulations, the old basis is written off and a loss is recognized as opposed to continuing to depreciate the old property. The disadvantage is that a replacement must be capitalized, even if it would otherwise be considered a repair. If the taxpayer has capitalized the building as one unit and has not tracked the components of the building, recordkeeping can be burdensome. Taxpayers must use a reasonable method to determine the basis for the disposition and this method must be consistently applied to all dispositions. A cost segregation ("cost seg") study breaks down a building into its various components. Not only are assets identified as §1245 property depreciated under shorter lives, these components are also easily identified if a subsequent disposition occurs.

Cost seg studies allow the breakdown necessary for making a General Asset Account ("GAA") election as discussed in a later section.

Revenue Procedures under the Regs

Two revenue procedures ("Rev.Proc") were issued in 2012 to provide guidance on how taxpayers can obtain automatic consent to comply with the new regulations. Rev. Proc 2012-19 provides guidance on changes to repairs and maintenance, and materials and supplies while Rev. Proc 2012-20 addresses changes to depreciation and disposition. These Rev Procs do not need to be implemented until 2014; however, early implementation for tax years beginning January 1, 2012 is allowed.

Rev. Proc. 2012-19

Rev. Proc 2012-19 provides automatic change procedures for 13 different method changes. A change to comply with the regulations is a change in accounting method, so many of these changes are mandatory. The following are the changes under Rev Proc 2012-19:

1. Deducting repair and maintenance costs. This change is for taxpayers that want to change from capitalizing costs paid or incurred for tangible personal property to deducting these expenditures as repairs and maintenance costs under Code Section 162. This change also allows taxpayers to change its units of property solely for purposes of determining if the amounts paid or incurred improve a UoP.
2. Changing to a regulatory accounting method. This change applies to regulated taxpayers, such as regulated utilities, who wish to change to a method used for regulatory accounting purposes to determine if amounts paid or incurred are repairs or improvements.
3. Deducting non-incidental materials and supplies when used or consumed. A change under this procedure is for taxpayers that want to change to deducting these amounts in the tax year these items are actually used or consumed.
4. Deducting incidental materials and supplies when paid or incurred. This change is for taxpayers that wish to change to the method of deducting these amounts in the tax year in which these items are paid for or incurred.
5. Deducting non-incidental rotable and temporary spare parts when disposed of. Taxpayers electing this change want to change their method of accounting to deduct costs for non-incidental rotable and temporary spare rates in the year in which the parts are disposed of by the taxpayer.
6. Changing to the optional method for non-incidental rotable and temporary spare parts. This change relates to a taxpayer that wishes to change to the optional method of accounting that includes five steps from initial installation, removal, repair or improvement of the part, reinstallation and finally disposition.
7. Deducting dealer expenses facilitating the sale of property. Dealers in property may change the method of accounting to treat commissions or other costs paid to facilitate the sale of property as ordinary and necessary business expenses rather than capitalizing these expenses.

8. Deducting de minimis amounts. This change applies to taxpayers who wish to apply the de minimis rule under the regs. Taxpayers who have applicable financial statements and are following book treatment for expensing small amounts would be eligible for this change.
9. Deducting applicable costs for investigating or pursuing acquisition of real property. Taxpayers who wish to change from capitalizing to deducting investigative costs would file under this method. Costs that are facilitative or inherently facilitative would not be eligible for this change.
10. Changing to the safe harbor for routine maintenance. This change would expense amounts that are paid or incurred for routine maintenance as these costs would not be considered an improvement. The routine safe harbor does not apply to buildings or structural components of buildings.
11. Capitalizing non-dealer costs to facilitate the sale of property. A taxpayer would apply for this change if they incur commissions or other costs paid or incurred to facilitate the sale of property. These costs need to be capitalized under the regs and cannot be deducted currently.
12. Capitalizing and depreciating acquisition or production costs. Taxpayers need to change their method of accounting to capitalize costs incurred to acquire or produce property and to subsequently depreciate these costs.
13. Capitalizing and depreciating improvements to real property. Taxpayers need to change their method of accounting to capitalize amounts paid or incurred for improvements to UoP's and to subsequently elect to depreciate these improvements.

Rev Proc 2012-20

Rev Proc 2012-20 modifies Rev. Proc 2011-14 and adds six automatic changes.

1. Depreciation of leasehold improvements. A taxpayer must file for a change if they have been depreciating an asset incorrectly over the lease term rather than over the appropriate cost recovery method.
2. Changing from one permissible method of MACRS depreciation to another. This change would apply to taxpayers that may want to make a change in accounting for asset accounts (i.e. from a single asset account to a multiple asset account) or for dispositions from these accounts (such as from specific identification to FIFO).
3. Disposition of buildings or structural components. This change would allow taxpayers to write off dispositions and recognize a gain or loss rather than continuing to depreciate the property. The change may also require capitalization under the restoration rule. Property for which a valid GAA election has been made is excluded.
4. Disposition of tangible depreciable assets other than a building or its structural components. Basically the same as the previous method change but for §1245 property (personal property).
5. Disposition of assets in a GAA. A taxpayer will make this change to dispose of assets in a GAA. This would allow a taxpayer to dispose of an asset and recognize a loss and to change the method of recognizing the assets disposed of. This would also impact repairs that must be capitalized under the restoration rules.

6. GAA elections. If a taxpayer does not have a prior GAA election in place, this change would allow for a late election for those tax years beginning prior to 1/1/12. This would also allow a taxpayer to recognize gain or loss on prior dispositions. Further discussion of the advantages of electing a GAA is discussed in the next section.

General Asset Accounts ("GAA")

Assets may be accounted for in a single asset account, a multiple asset account or pool or a GAA. Assets accounted for in a single asset account are separately depreciated. Some assets must be depreciated in a single asset account:

1. Assets used only partially for business.
2. Assets placed in service and disposed of in the same tax year.
3. Assets in a general asset account and the general asset account terminates for this asset.
4. A component of a larger asset that is disposed of and the unadjusted basis of the component is included in the unadjusted basis of the larger asset.

Multiple asset accounts and General Asset Accounts ("GAA") are very similar. Both methods require that assets in each of these accounts be placed in service in the same year, have the same depreciation method, convention (half year, mid-quarter, etc.) and recovery period. Assets no longer have to be in same asset class as under prior regs. The difference between the two methods is how a gain or loss on disposition is calculated.

A GAA election gives taxpayers greater flexibility in regards to the disposition of assets. The regs now allow a taxpayer to terminate GAA treatment for a single asset. Thus, electing to group assets in a GAA allows the taxpayer to either claim a loss on disposition and capitalize the new restoration, or to continue depreciating the old asset and deduct the restoration as repairs and maintenance if applicable.

An example of the advantages of electing GAA treatment is as follows

Facts

- Company purchased a building on 1/1/2008 for $10 million
- A cost segregation study determined the cost allocated to the roof was $150,000
- In 2012, the roof was repaired at a cost of $200,000. This repair did not result in betterment or a restoration.
- Accumulated depreciation on the roof was $15,000

Conclusion

Late GAA election not made	Late GAA Election Made
Old roof disposed, loss of $135,000 recognized	Continue to depreciate the old roof
New roof repairs of $200,000 must be capitalized and depreciated over 39 years	The $200,000 repair is expensed

Thus, electing GAA treatment (in this case a late election to be discussed in the next section) results in an additional tax deduction of $65,000 in the year the roof was repaired.

Form 3115

As stated previously, a change to conform to the temporary regs is a change in accounting method. Even if a taxpayer is currently using a method of accounting that is not a proper method and the taxpayer is changing to the correct method, Form 3115 must be prepared to file for an automatic method change. Most of the method changes listed above will require a catch-up adjustment which is referred to as a Section 481(a) adjustment. This adjustment captures the cumulative difference between the current and proposed methods of accounting.

Rev. Procs. 2012-19 and 2012-20 allow taxpayers filing for any of the new changes to file for all of the changes concurrently on a single Form 3115. For each individual item the present and proposed method and the Section 481(a) adjustment must be specified for each change.

If a negative adjustment is generated by one or more of the changes on a single Form 3115 and the other changes generate a positive adjustment, a single negative Section 481(a) adjustment for the negative adjustments and a single Section 481(a) adjustments for the positive adjustments may be included in Form 3115. A net negative adjustment (additional deduction) is taken into income entirely in year one. If the adjustment is an addition to income, this adjustment can be spread over four years. There is no statute of limitations for accounting method changes.

Some of the methods require a cut-off adjustment. These method changes will not have a catch-up adjustment. Instead, only items that arise on or after the beginning of the year the change is implemented will be accounted for under the new method. The following automatic change methods will have a cut-off adjustment:

- Deduction of non-incidental materials and supplies
- Deduction of incidental materials and supplies
- Deduction of non-incidental rotable and temporary spare parts
- Deduction of de minimis amounts
- Deduction of investigative costs and costs incurred pursuing the acquisition of real property

Changes in depreciable lives under a cost segregation study also require the completion of Form 3115. These changes need to be filed under a separate Form 3115 as the regs do not address changes in depreciable lives except for leasehold improvements that have been incorrectly depreciated over the lease term rather than the appropriate cost recovery life.

IRS Audit Protection

Taxpayers who file for the automatic method changes receive IRS assurance of audit protection for prior years. The protection begins on the date Form 3115 is filed with the appropriate IRS service center. IRS agents have been instructed to discontinue any current activity and not begin any new activity with respect to capitalization issues. As mentioned previously, taxpayers who file Form 3115 can also elect to spread the Section 481(a) adjustment over four years. If the adjustment is made under an IRS exam, the adjustment is taken into income in one year, with interest and penalties if applicable.

References

Reg §1.162-3T. Materials and supplies (temporary)

Reg §1.168(i)-1T. General asset accounts.

Reg §1.168(i)-8T. Dispositions of MACRS property (temporary).

Reg §1.263(a)-2T. Amounts paid to acquire or produce tangible property (temporary).

Reg §1.263(a)-3T. Amounts paid to improve tangible property (temporary).

Rev. Proc. 2012-19

Rev. Proc. 2012-20

About Scarpello Consulting

Launched in 2001, Scarpello Consulting provides Cost Segregation consulting services to help clients maximize their depreciation allowances while minimizing audit risk. The firm has four locations including Los Angeles, CA, Omaha, NE, Overland Park, KS and New York City, NY. Additional information is available at www.ScarpelloConsulting.com.