
WNTS Insight

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The tangible property repair regulations: effective dates, units of property, and dispositions

This WNTS Insight is the first in a three-part series that will discuss in depth the recently issued proposed and temporary regulations regarding the deduction and capitalization of expenditures related to tangible property. This Insight will discuss rules related to effective dates, units of property, and dispositions. The second WNTS Insight in this series will discuss rules related to the acquisition or improvement of property. The third will discuss additional topics not previously discussed, including rotatable spare parts, environmental remediation, general asset accounts, the recovery of capital improvements subject to lease, and removal costs. (For prior coverage, see WNTS Insight, "[Proposed/temporary tangible capitalization regulations: High-level overview](#)," December 27, 2011.)

Background

The IRS on December 23, 2011, published regulations (in proposed and temporary form) under section 263(a) on the deduction and capitalization of expenditures related to tangible property (the repair regulations or temporary regulations). The repair regulations have been a priority guidance project for approximately eight years, having been announced initially in 2004 in an Advance Notice of Proposed Rule Making, proposed in regulations in August 2006, and then repropounded in March 2008 (the 2008 proposed regulations). The repair regulations are significantly different in many respects from prior law as well as from the 2006 and 2008 proposed versions of these regulations. The new regulations contain provisions that may be beneficial for some taxpayers but unfavorable for others.

The temporary regulations serve as the text for the proposed regulations. The IRS requests comments on all aspects of the newly proposed regulations by March 26, 2012. In addition, the IRS has scheduled a public hearing on the repair regulations



on April 4, 2012. Topics to be discussed at the hearing must be submitted by March 21, 2012.

Effective Dates and Changes in Methods of Accounting

Effective dates of temporary regulations

The entirety of the repair regulations are temporary regulations that generally apply for tax years beginning on or after January 1, 2012, and expire on December 23, 2014. However, the following portions of the temporary regulations apply for amounts paid or incurred in tax years beginning on or after January 1, 2012:

- Materials and supplies (Temp. Reg. sec. 1.162-3T);
- The special rule for costs related to the acquisition of real property (Temp. Reg. sec. 1.263(a)-2T(f)(2)(iii));
- Employee compensation and overhead costs related to the acquisition or production of property (Temp. Reg. sec. 1.263(a)-2T(f)(2)(iv));
- The treatment of inherently facilitative amounts related to the acquisition or production of property (Temp. Reg. sec. 1.263(a)-2T(f)(3)(ii));
- The de minimis rule or "capitalization threshold" related to the acquisition or production of property (Temp. Reg. sec. 1.263(a)-2T(g));
- Production costs of property subject to the acquisition of property de minimis rule or capitalization threshold (Temp. Reg. sec. 1.263A-1T(b)(14));
- The recovery of costs capitalized under section 263A (Temp. Reg. sec. 1.263A-1T(c)(4));
- Section 263A direct material costs (Temp. Reg. sec. 1.263A-1T(e)(2)(i)(A));
- Section 263A indirect material costs (Temp. Reg. sec. 1.263A-1T(e)(2)(ii)(E)); and
- Changes in method of accounting for costs subject to the de minimis rule or capitalization threshold (Temp. Reg. sec. 1.263A-1T(l)).

Changes in method of accounting

In general, a change to comply with the temporary regulations is a change in method of accounting to which the provisions of section 446(e) and the regulations thereunder apply. Accordingly, beginning in 2012, all taxpayers likely will have to change their method of accounting to conform to these regulations.

The repair regulations generally require a full section 481(a) adjustment, which means taxpayers need to evaluate their current method of accounting for repairs to determine what changes, if any, are required to conform to these new rules. However, the de minimis rule and several other provisions are implemented on a cut-off basis rather than with a section 481(a) adjustment.

Observation: The general requirement that the temporary regulations require a section 481(a) adjustment will require taxpayers that currently use a *more* favorable method of accounting for repairs than permitted under the repair regulations to give back some of the benefit. Likewise, taxpayers that currently use a *less* favorable method will be able to claim missed repair deductions. If a section 481(a) adjustment is required, the cumulative effect -- including any section 481(a) adjustment(s) from prior repairs method changes -- must be reflected in the adjustment.

Observation: The IRS noted in the preamble to the temporary regulations that the imposition of a section 481(a) adjustment provides for a uniform and consistent rule for all taxpayers that will reduce the administrative burden on taxpayers and the IRS. Further, requiring a section 481(a) adjustment ensures that all taxpayers are on the same method of accounting for costs incurred both before and after the effective date of the temporary regulations. Despite these administrative gains, any taxpayer that previously incurred expenses to repair or improve tangible property will be required to conform all prior years' expenditures to the rules contained in the temporary regulations. In particular, for those taxpayers that performed a repairs study in the past, such taxpayers likely will have to revisit those studies and analyze their past-year expenditures in accordance with the temporary regulations.

Pending guidance

Two related revenue procedures are expected to be issued that will provide procedures under which taxpayers may obtain automatic consent to change their methods of accounting to conform to the temporary regulations for tax years beginning on or after January 1, 2012.

Because many of the rules contained in the temporary regulations are rules of first impression relative to prior law, it is expected that most, if not all, taxpayers will have to request a change in method of accounting to comply with the temporary regulations. Taxpayers that have filed a Form 3115 to request a change in their method of accounting for repair and maintenance costs but have not yet filed their federal income tax return for the year of change may want to await further guidance from the IRS addressing the transition rules prior to filing such federal income tax return, if they can.

Observations: The accounting method change procedures issued in 2011 for repair expenditures incurred by electric utility taxpayers with electric transmission and distribution assets, as well as taxpayers in the telecommunications industry, each provided audit protection for deductions taken on originally filed returns for such taxpayers upon filing a change in method of accounting application to conform to the new repairs guidance. As a result, it is anticipated that the forthcoming accounting method change procedures to conform to the temporary regulations will similarly afford audit protection for all tax years prior to the tax year for which a taxpayer changes its method of accounting to conform to the temporary regulations. Securing audit protection often provides significant financial accounting and federal and state income tax benefits. As a result, taxpayers may seek to file their accounting method changes as soon as possible to secure audit protection. However, taxpayers with natural gas distribution and/or electric generation assets may wish to wait for the release of the specific guidance related to those assets under the IRS industry issue resolution (IIR) program.

Observation: It is unclear whether the IRS Large Business and International Division (LB&I), in response to these new repair regulations, will issue a directive similar to those recently issued for electric transmission and distribution assets and telecommunications companies, which provided auditing guidelines for IRS exam agents on prior repairs methods changes. Given the IRS's policy goal to treat similarly situated taxpayers in the same manner, it is possible that similar directives will be issued in the future.

Unit of Property

The 2008 proposed regulations generally defined a unit of property (UOP) as consisting of all the components of a UOP that are functionally interdependent. Special rules were provided for buildings, plant property, and network assets. The 2008 proposed regulations did not contain UOP rules for leased property. For property other than buildings, the 2008 proposed regulations further refined the UOP by treating a functionally interdependent component as a separate UOP if the taxpayer initially assigned a different economic useful life to the component for financial statement or regulatory purposes or if the taxpayer assigned a different class or recovery method under the modified accelerated cost recovery system (MACRS) of section 168 to the component. This additional rule is discussed in further detail below.

As discussed below, the repair regulations do not retain the aforementioned financial statement or regulatory conformity rules. In addition, the repair regulations introduce significant changes as to what constitutes the UOP with respect to a building and its structural components. Most other rules for determining the UOP are retained in the repair regulations, with minor exceptions.

Buildings and structural components

The repair regulations provide that a UOP for a building is comprised of the building and its structural components. However, taxpayers are required to apply repairs standards *separately* to the building structure and specifically defined building systems. Building systems are defined to include only:

- Heating, ventilation, and air conditioning systems (HVAC);
- Plumbing systems;
- Electrical systems;
- All escalators;
- All elevators;
- Fire protection and alarm systems;
- Security systems;
- Gas distribution systems; and
- Any other systems defined in published guidance.

Observation: The "componentization" of a building into multiple UOPs is a significant change from prior law, under which most taxpayers likely treated the building inclusive of all the aforementioned building systems as one collective UOP. These new UOP definitions, combined with the imposition of a section 481(a) adjustment to conform to the temporary regulations, will require taxpayers to analyze all of their buildings to determine the impact of these new UOP rules on prior-year repair expenditures.

Observation: A roof, while not explicitly referenced in the definition of a UOP in the repair regulations, is included in the meaning of building structure under the investment tax credit regulation (Reg. sec. 1.48-1(e)(1)) and incorporated by reference into the definition of a building in the repair regulations.

With respect to a condominium, the UOP is the individual unit owned by the taxpayer and the structural components that are part of the condominium unit. Similarly, for a taxpayer that has an ownership interest in a cooperative housing corporation, the UOP is the portion of the building in which the taxpayer has possessory rights and the structural components that are part of the portion of the building subject to the taxpayer's possessory rights.

When a lessee makes an improvement to a leased building, the general UOP building rules are applicable, with the additional rule that the lessee's UOP may not be larger than its leased portion of the building, if less than the whole building.

Property other than buildings

The repair regulations retain the functional interdependence test noted above as the general rule for determining the UOP for real and personal property other than buildings, such as manufacturing equipment, office equipment and furniture, and vehicles. The repair regulations, however, do not include the rule contained in the 2008 proposed regulations that 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 statement or regulatory purposes. The exclusion of this rule from the repair regulations reduces the administrative complexity of the temporary regulations.

Additional key provisions of the UOP rules for property other than buildings include:

- *Plant property:* The repair regulations retain the rule that the UOP for plant property generally is comprised of each component (or group of components) within the plant that performs a discrete and major function or operation within functionally interdependent machinery and equipment.
- *Network assets:* The definition of network assets retains an operative rule providing that a UOP is determined by the taxpayer's particular facts and circumstances except as otherwise provided in guidance published in the Federal Register or the Internal Revenue Bulletin. The functional interdependence test is not determinative for network assets; previously issued guidance on network assets, such as telecommunications network assets, is not modified by the new regulations.

Observation: The IRS notes in the preamble to the repair regulations that the determination of UOPs for network assets is more appropriately addressed through the IIR program. As noted earlier, the IRS already has issued guidance for electric transmission and distribution network assets and telecommunication network assets, and is currently working on additional IIRs related to the appropriate UOP for the natural gas and cable television industries as well as electric generation assets.

- *Leased property other than leased buildings:* The lessee's UOP for leased real or personal property other than building property is determined under the general rules for property other than buildings, including the functional interdependence test and the plant property rule (as applicable), except that, after applying those rules, the UOP may not be larger than the property subject to lease.

UOP for leasehold improvements

Amounts initially capitalized as a lessee improvement are treated as a cost of acquiring or producing a UOP and constitute a UOP *separate* from the leased property being improved. This new property interest is deemed separate and distinguishable from the lessee's interest in the underlying property. However, the cost of improving the lessee improvement is not a UOP separate from the lessee improvement being improved. Additionally, amounts capitalized as a lessor improvement are not a UOP separate from the UOP improved.

Additional rules for determining UOP

Regarding property other than buildings, the 2008 proposed regulations provided that a component must be treated as a separate UOP if, at the time the UOP is placed in service by the taxpayer, the taxpayer has recorded on its books and records for financial or regulatory accounting purposes, an economic useful life for the component that is different from the economic useful life of the UOP of which the component is a part (the book consistency rule). The 2008 proposed regulations also provided that a component must be treated as a separate UOP if the taxpayer has properly treated the component as being in a different MACRS class than the class of the UOP of which the component is a part, or depreciated the component using a section 167 or 168 depreciation method different from the depreciation method for the UOP of which the component is a part (the depreciation consistency rule). The temporary regulations do not adopt the book life consistency rule, but retain the depreciation consistency rule and add a second depreciation consistency rule, which applies if a taxpayer or the IRS properly changes the MACRS class or depreciation method for any type of property in a tax year after the year the property was initially placed in service.

Dispositions

Definition

In general, a disposition under the repair regulations occurs when ownership of an asset is transferred or the asset is permanently withdrawn from use. A disposition of an asset includes sale, exchange, retirement, physical abandonment, destruction, and transfer to a supplies, scrap, or similar account. The temporary regulations also provide that the definition of disposition for MACRS property is expanded to include the retirement of a structural component of a building. Accordingly, the temporary regulations allow the recognition of a loss upon such retirement. In some cases, components of section 1245 property may be treated as the asset disposed of. These changes will allow taxpayers to claim a retirement loss for worn or damaged components that are discarded from the taxpayer's operations.

Observation: A taxpayer that has made an election to capitalize materials and supplies must obtain IRS consent to revoke such election before it may dispose of such property by transferring it to a supplies account.

Observation: Allowing a taxpayer to claim a retirement loss for a structural component of a building or major building system permits a taxpayer to claim a retirement loss where such structure or system is replaced with a capital improvement. This is an equitable result that does not require a taxpayer to depreciate, for example, an electrical system that has been removed and replaced with an updated system.

With respect to buildings and associated structural components, taxpayers continue to be required to use composite depreciation. Under composite depreciation, taxpayers use the same recovery period and depreciation method for both the building and the structural components. Even though each of the structural components is viewed as a separate asset, composite depreciation is still a requirement.

The repair regulations do not address the determination of basis of certain assets retired or replaced. In situations in which component parts of a larger asset (for example, an HVAC unit as part of a larger older asset) are to be replaced subsequent to the repair, replacement, or improvement of the underlying older asset, the repair

regulations do not provide guidance as to how to determine the cost basis and net tax value of the component part (i.e., the HVAC unit) upon its replacement.

Observation: Despite the aforementioned equitable results that the retirement loss rule may afford, such results likely will come with some administrative burden. Most taxpayers do not assign separate basis values between a building and the building's systems upon acquisition of a building. To claim such a loss, taxpayers will have to determine the adjusted tax basis in such retired components or building systems.

Gain or loss

The repair regulations provide rules for determining gain or loss upon the disposition of MACRS property that are consistent with the disposition rules under Prop. Reg. sec. 1.168-6 (the proposed accelerated cost recovery system (ACRS) regulations). If an asset is disposed of by sale, exchange, or involuntary conversion, gain or loss is recognized under the applicable provisions of the Code. If an asset is disposed of by physical abandonment, loss is recognized in the amount of the asset's adjusted depreciable basis at the time of the abandonment. However, if the abandoned asset is subject to nonrecourse indebtedness, the temporary regulations clarify that the asset is treated in the same manner as an asset disposed of by sale.

If an asset is disposed of by conversion to personal use, no gain or loss is recognized. If an asset is disposed of other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use, gain is not recognized but loss is recognized in the amount of the excess of the asset's adjusted depreciable basis over its fair market value at the time of disposition.

Asset disposed of

In determining the appropriate asset disposed of, the repair regulations provide that the facts and circumstances of each disposition are taken into account. In general, the asset for disposition purposes cannot be larger than the UOP. However, each disposed-of building is the asset except if more than one building is treated as the asset under Reg. sec. 1.1250-1(a)(2)(ii). Additionally, consistent with the expansion of the definition of a disposition to include a retirement of a structural component of a building, the repair regulations provide that each structural component of a building is the asset for disposition purposes. Further, if the taxpayer properly includes an item in one of the asset classes 0.11 through 00.4 of Rev. Proc. 87-56 or classifies an item in one of the categories under section 168(e)(3), then each item is the asset, provided it is not larger than the UOP. The repair regulations also provide that a taxpayer generally may use any reasonable, consistent method to treat each of an asset's components as the asset for disposition purposes.

The temporary regulations also provide specific rules for determining the placed-in-service year of the asset disposed of. Generally, the taxpayer must use the specific identification method to identify the asset disposed of.

Accounting for assets disposed of

In situations in which determining the unadjusted depreciable basis of an asset may be impracticable because the asset is accounted for as part of a multiple asset account, the repair regulations provide that a taxpayer may use any reasonable, consistent method to determine the basis of the asset disposed of. Upon disposition, the asset is removed from the multiple asset account and the unadjusted depreciable basis and the depreciation reserve of the account are adjusted.

Dispositions from general asset accounts

Temp. Reg. sec. 1.168(i)-1T makes a variety of changes to the existing rules under section 168(i)(4) regarding dispositions of assets from general asset accounts. Consistent with the expansion of the definition of disposition of MACRS property, the temporary regulations expand the definition of disposition under Reg. sec. 1.168(i)-1(e)(1) to include a retirement of a structural component of a building.

The existing rules for general asset accounts allow a taxpayer to elect to terminate general asset account treatment for an asset in a general asset account when the taxpayer disposes of the asset in a "qualifying disposition"; the repair regulations expand the definition of qualifying disposition to include most dispositions.

The repair regulations retain the existing rule that a taxpayer may use any reasonable method that is consistently applied to all of its general asset accounts for determining the unadjusted depreciable basis of an asset for which general asset account treatment is terminated. Consistent with the repair regulations for dispositions from multiple asset account, the repair regulations provide that the following methods are reasonable for identifying the placed-in-service year of the asset disposed of from the general asset account:

- Specific identification;
- First-in, first out (FIFO);
- A modified FIFO method;
- A mortality dispersion table if the asset disposed of is a mass asset grouped in a general asset account with other mass assets; or
- Any method designated by the Secretary.

The last-in, first-out (LIFO) method specifically is not permitted.

Dispositions from multiple asset accounts

The IRS recognizes that if a taxpayer accounts for assets in multiple asset accounts, it may be impracticable to determine from the taxpayer's records when the asset disposed of was placed in service. Accordingly, the repair regulations allow the taxpayer to use a FIFO method under which the taxpayer treats the asset disposed of as being from the multiple asset account with the earliest placed-in-service year that has assets with the same recovery period as the asset disposed of or, if the specific year the asset was placed in service is identifiable, from the multiple asset account for the year the asset was placed in service. If the asset disposed of is a mass asset in a multiple asset account, the repair regulations also allow the taxpayer to use a mortality dispersion table to identify when the asset was placed in service.

Consistent with the rules applicable to dispositions from general asset accounts, the use of a LIFO method specifically is not permitted.

In situations in which determining the unadjusted depreciable basis of an asset may be impracticable because the asset is accounted for as part of a multiple asset account, the repair regulations provide that a taxpayer may use any reasonable, consistent method to make that determination. Upon disposition, the asset is removed from the multiple asset account and the unadjusted depreciable basis and the depreciation reserve of the account are adjusted.

Observation: If a taxpayer can readily determine from its records the unadjusted depreciable basis of the asset disposed of, the repair regulations allow the taxpayer to use a FIFO method under which the taxpayer treats the asset disposed of as being

from the multiple asset account with the earliest placed-in-service year that has assets with the same recovery period as the asset disposed of and with the same unadjusted depreciable basis as the asset disposed of or, if the specific year the asset was placed in service is identifiable, from the multiple asset account for the year the asset was placed in service.

Link to registration for January 19 PwC Webcast on the repair regulations:

<http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=393301&sessionid=1&key=5F824A9363C2819ABC45DCC72485E6EA>

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