WNTS Insight

A Washington National Tax Services (WNTS) Publication

January 5, 2012

The tangible property repair regulations: Acquisition or improvement of property

This is the second WNTS Insight in a three-part series that discusses in depth the recently issued temporary and proposed regulations regarding the deduction and capitalization of expenditures related to tangible property (the temporary regulations or repair regulations). The first Insight discussed rules related to effective dates, units of property, and dispositions. (See WNTS Insight, "The tangible property repair regulations: effective dates, units of property, and dispositions," January 4, 2012.) This Insight discusses rules related to the acquisition or improvement of property. The third will include a discussion of rotable spare parts, environmental remediation, general asset accounts, the recovery of capital improvements subject to lease, and removal costs.

Acquisition or production of new property

Temp. Reg. sec. 1.263(a)-2T provides taxpayers with guidance on whether to capitalize costs related to the acquisition or production of tangible property. The rules related to such costs generally are the same as provided in the 2008 proposed regulations, with clarifications and modifications to certain sections, including moving and installation costs, transaction costs, and the de minimis rule.

Under the temporary regulations, taxpayers generally must capitalize the cost of acquiring or producing new personal and real property. Amounts paid that must be capitalized include the invoice price, costs paid to defend or perfect title of the property, transaction costs, and costs for work performed prior to the date the unit of property (UOP) is placed in service. The temporary regulations follow section 263A and the regulations thereunder for the types of costs required to be capitalized for property produced or acquired by the taxpayer. The temporary regulations also



provide a de minimis rule exclusion as well as rules for the cost of materials and supplies that may be deducted.

Meaning of "produce"

The meaning of "produce" has not changed from the 2008 proposed regulations. The temporary regulations provide that "produce" generally has the same meaning as in section 263A(g)(1) and Reg. sec. 1.263A-2(a)(1)(i), with the exception of "improve," which is defined separately in the temporary regulations.

Materials and supplies

The framework set forth in the 2008 proposed regulations for materials and supplies generally is retained, including the \$100-or-less threshold. However, the repair regulations modify and expand the definition of materials and supplies, provide an alternative optional method of accounting for rotable and temporary spare parts (to be discussed in the next WNTS Insight in this series), and provide an election to treat certain materials and supplies under the de minimis rule (see further discussion in the de minimis section below).

With regard to the definition of materials and supplies, the repair regulations redefine the first category to describe further the types of components that qualify as such and remove the requirement that such property not be a UOP under Temp. Reg. sec. 1.263(a)-3T(d)(2). Further, the repair regulations add a category to the definition of materials and supplies to include fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations.

The temporary regulations are consistent with the prior-law rules that non-incidental materials and supplies are deductible as used or consumed, while incidental materials and supplies are deductible when purchased if no consumption records or no inventories are maintained, provided taxable income is clearly reflected. However, taxpayers may elect annually to capitalize and depreciate materials and supplies by making such election on a timely filed federal income tax return, including extensions, for the tax year the asset is placed in service by the taxpayer for purposes of determining depreciation.

Observation: Although the repair regulations retain the \$100-or-less threshold for materials and supplies, the regulations add language that provides the IRS the flexibility to change the amount of the threshold in future published guidance.

De minimis rule

The repair regulations continue to provide the de minimis rule first established in the 2008 proposed regulations, under which amounts paid to acquire or produce tangible property (including facilitative costs) and, at the election of the taxpayer, to acquire or produce any material or supply would not be required to be capitalized, with two main exceptions.

First, <u>for acquired property</u>, the repair regulations continue to include a de minimis rule under which a taxpayer may expense the cost of acquired property that does not exceed a certain dollar threshold. However, the repair regulations provide a revised "ceiling" threshold that the aggregate of such amounts paid cannot exceed. Such ceiling caps the aggregate amount deductible for the tax year to an amount that is less than or equal to the greater of (i) 0.1 percent of the taxpayer's gross receipts for the

tax year as determined for federal income tax purposes, or (ii) 2 percent of the taxpayer's total depreciation and amortization expense for such tax year as determined in its applicable financial statement (AFS). However, the repair regulations de minimis rule is available only to taxpayers with an AFS. Accordingly, taxpayers without an AFS cannot take advantage of the de minimis rule.

Second, <u>amounts paid for materials and supplies</u> are subject to the de minimis rule only if the taxpayer elects to treat them as such. Thus, a taxpayer that desires to apply the de minimis rule to any material or supply makes the election by deducting the amounts of the materials and supplies in the tax year in which the amounts are paid.

Additionally, the repair regulations do not include the exceptions from the de minimis rule in the 2008 proposed regulations for property acquired for repairs and property acquired for improvements. Consequently, the de minimis rule under the repair regulations may be applied to these categories.

Observation: The preamble to the repair regulations states that the de minimis rule is not intended to prevent a taxpayer from reaching an agreement with its IRS examining agent that, as an administrative matter, based on risk analysis or materiality, the agent will not review certain items. Additionally, if an examining agent and the taxpayer agree that certain amounts in excess of the de minimis rule ceiling are immaterial and should not be subject to review, then that agreement should be respected, notwithstanding the requirements of the de minimis rule in the repair regulations. However, the preamble states that taxpayers that seek a deduction for amounts in excess of the amount allowed by this rule or by an agreement with an exam agent will have the burden of showing that such treatment clearly reflects income.

Observation: The lack of outright financial statement conformity in favor of a mathematical ceiling likely will cause some administrative computational burdens for taxpayers. To compute the ceiling, taxpayers now will need to determine the total cost of newly acquired assets that have been expensed during the tax year for financial statement purposes, which is something that often is not tracked by businesses.

Transaction costs

The temporary regulations retain many of the transaction cost concepts provided in the 2008 proposed regulations. Amounts paid to facilitate the acquisition of a UOP must be capitalized. The temporary regulations provide that facilitative costs generally include amounts paid in the process of investigating or otherwise pursing the acquisition. Whether costs are facilitative is based on the facts and circumstances of the acquisition.

Inherently facilitative costs must be capitalized. The list of inherently facilitative costs in the temporary regulations, which has not changed from the 2008 proposed regulations, includes:

- Transporting the property (for example, shipping fees and moving costs);
- Securing an appraisal or determining the value or price of property;
- Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;
- Application fees, bidding costs, or similar expenses;

- Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);
- Examining and evaluating the title of property;
- Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;
- Conveying property between the parties, including sales and transfer taxes, and title registration costs;
- Finders' fees or brokers' commissions, including amounts paid that are contingent on the successful closing of the acquisition;
- Architectural, geological, engineering, environmental, or inspection services pertaining to particular properties; and
- Services provided by a qualifying intermediary or other facilitator of an exchange under section 1031.

Inherently facilitative costs must be capitalized even if the real or personal property is not acquired or produced. If the acquisition is abandoned, the costs may be recovered as a loss under section 165. In all other situations, the inherently facilitative costs may be allocated to those properties and recovered under section 167 or section 168, as appropriate.

The treatment of employee compensation and overhead costs related to transactions has not changed from the 2008 proposed regulations. Accordingly, amounts paid by a taxpayer for employee compensation and overhead costs are not treated as facilitative costs unless the taxpayer elects to capitalize those costs. The election may be for either or both types of costs, and is made on a transaction-by-transaction basis.

Real property

Activities performed by a taxpayer to determine whether to acquire real property, and which real property to acquire, are not required to be capitalized unless the cost is considered an inherently facilitative cost. Therefore, such pre-decisional investigative or pursuit costs for real property generally need not be capitalized.

The temporary regulations provide a new reasonable allocation rule for taxpayers that acquire real and personal property as part of a single transaction. The allocation will allow taxpayers to deduct pre-decisional investigative costs related to the acquisition of real property while requiring such costs related to the acquisition of personal property to be capitalized.

Note: After the release of the 2008 proposed regulations, some commentators requested that the deduction allowed for the investigation and pursuit of real property be extended to personal property. The IRS states in the preamble to the temporary regulations that the benefit was not extended to personal property because of the amount of controversy that likely would arise over relatively small amounts.

Amounts paid to improve tangible property

The temporary regulations provide taxpayers with guidance on how to treat expenditures for the improvement of tangible property. Specifically, improvements to tangible property generally must be capitalized. A UOP has been improved after it has been placed in service if the activity performed on the property:

• Results in a betterment to the UOP (betterments):

- Restores the UOP (restorations); or
- Adapts the UOP to a new or different use.

Inherent in these distinctions is the "put versus keep" test. Under this test, as discussed in *Estate of Walling v. Commissioner*, 373 F.2d 190, 192-193 (3d Cir. 1966), an expenditure is deductible if it keeps the UOP in ordinary working condition. However, an expenditure must be capitalized if it puts the UOP in efficient operating condition, or adapts the UOP for a different use.

Betterments

The repair regulations retain the concepts of the 2008 proposed regulations for determining when a taxpayer must capitalize amounts paid that result in the betterment of a UOP. In general, the temporary regulations provide that an amount would result in a betterment if it:

- Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the UOP or arose during the production of the UOP, whether or not the taxpayer was aware of the condition or defect at the time of the acquisition or production;
- Results in a material addition (including a physical enlargement, expansion, or extension) to the UOP; or
- Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the UOP or the output of the UOP.

Consistent with the 2008 proposed regulations, the repair regulations do not provide any bright-line tests as to what constitutes a "material" addition or a "material" increase in capacity. However, the repair regulations provide a number of new examples to help illustrate the application of when a betterment has occurred, and therefore, when an amount paid in connection with the betterment must be capitalized.

The examples take into consideration the facts and circumstances of the expenditure, the availability of replacement parts, and the need for comparison between the condition of the property immediately after the expenditure and the condition of the property immediately prior to the expenditure in cases in which a particular event necessitates an expenditure. In analyzing all the facts and circumstances that gave rise to the expenditure, the repair regulations require that taxpayers take into account the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on the UOP, and the taxpayer's treatment of the expenditure on its AFS.

Although the examples in the repair regulations do not provide a bright-line test for materiality, there are two examples that illustrate when a material increase in capacity has occurred. Specifically, examples 16 and 17 describe situations in which a taxpayer needs to increase the capacity of its factory and channel, respectively. In Example 16, the taxpayer replaces certain columns and girders in its factory to store supplies with a gross weight that is 50 percent greater than the previous load-carrying capacity of the storage area. Similarly, the taxpayer in Example 17 needs to deepen its channel to a depth of 20 feet from its current 10-foot depth to accommodate certain vessels. In each example, there is a material increase in capacity, which results in the capitalization of such expenditures.

The repair regulations also provide insight into building remodeling, particularly leaseholds. <u>Example 6</u> provides an example of a retailer that periodically updates the appearance of its stores by changing their layouts, relocating lighting fixtures, and

reconfiguring a small number of display tables. Retailers often will undertake these changes to refresh their stores and make them more attractive to their customers. A refresh of a store does not materially increase the store's capacity. The repair regulations conclude that this type of refresh -- and the related minor repair and maintenance costs -- does not rise to the level of a betterment. Accordingly, the related costs are not required to be capitalized.

In comparison, <u>Example 8</u> adds to the facts in Example 6 that the work performed to refresh the stores was incurred by reason of a substantial remodel of the taxpayer's stores. As part of the remodeling, the taxpayer will perform significant work to alter the appearance and layout of the stores to increase customer traffic and sales volume. Additional work to be performed includes replacing ceilings with acoustical tiles, upgrading electrical systems, rebuilding interior and exterior facades, and replacing carpet with ceramic flooring. The remodeling of the stores results in a material increase in quality of the stores. Accordingly, the taxpayer in Example 8 must capitalize amounts paid to remodel the stores, including any costs that directly benefit or are incurred by reason of the remodeling (e.g., amounts paid to replace doors, flooring, and walls). Additionally, amounts paid for the refresh are required to be capitalized because these costs directly benefitted or were incurred by reason of the overall remodeling project.

Observation: The examples offer conclusions on when an amount is required to be capitalized based on various fact patterns and assumptions. The examples are helpful in formulating a taxpayer's analysis but -- because of the subjectivity of the betterment standard -- do not provide a clear, objective definition of materiality. This uncertainty likely will lead to potential controversy between taxpayers and the IRS.

Appropriate comparison

The guidance for appropriate comparison of the condition of a UOP to determine if a betterment has occurred has not changed from the 2008 proposed regulations. Specifically, the taxpayer must compare the condition of the property immediately prior to the event that necessitated the expenditure to the condition of the property immediately after the expenditure.

If the expenditure is to correct for normal wear and tear, then a taxpayer must compare to the condition of the property immediately following the previous expenditure for normal wear and tear. Further, a taxpayer must compare to the condition of the property when it was placed in service if no prior wear-and-tear work has been performed.

Observation: The appropriate comparison rule for a UOP when a particular event necessitates the expenditure is similar to that set forth in *Plainfield Union*, 39 T.C. 333, 338 (1962).

Pre-existing defect

An expenditure results in a betterment that must be capitalized if the expenditure ameliorates a material condition or defect that existed prior to the acquisition of the property, or that arose during the production of the property. Consistent with the 2008 proposed regulations, the temporary regulations state that the cost to ameliorate the pre-existing defect must be capitalized regardless of whether the taxpayer was aware of the condition or defect prior to acquisition or production of the UOP. The repair regulations provide several examples that illustrate situations in which a pre-existing defect or condition exists.

Note: The IRS received many comments regarding the capitalization of costs to ameliorate a pre-existing defect. The IRS did not allow for the deduction of such expenditure in cases in which the taxpayer was unaware of the defect upon acquisition or production, noting that such a rule would not be consistent with case law and would be too subjective for an agent to determine whether the taxpayer was aware of the pre-existing defect.

Restoration

In general, the temporary regulations provide that a taxpayer must capitalize amounts paid to restore a UOP, including amounts paid in making good the exhaustion for which an allowance is or has been made. An amount is paid to restore a UOP if it:

- Is for the replacement of a component of a UOP and the taxpayer has properly deducted a loss for that component (other than a casualty loss under Reg. sec. 1.165-7);
- Is for the replacement of a component of a UOP and the taxpayer had properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- Is for the repair of damage to a UOP for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165;
- Returns the UOP to its ordinarily efficient operating condition if the property
 has deteriorated to a state of disrepair and was no longer functional for its
 intended use;
- Results in the rebuilding of the UOP to a like-new condition after the end of its economic useful life; or
- Is for the replacement of a major component or a substantial structural part of the UOP.

Observation: In general, replacements are treated like the acquisition of new property, and the amounts paid for the replacement or restoration of the entire property or components of that property are treated as capital expenditures and are recovered through depreciation over the proper recovery period. That is, the damaged part of the property is treated as retired, the basis attributable to the damaged part is removed, and the damaged part is restored or replaced.

The repair regulations generally retain the restoration standards set forth in the 2008 proposed regulations but have revised certain definitions as well as the operation and application of some of the rules.

With respect to casualty losses, the repair regulations retain the casualty loss rule under which an amount paid to restore a UOP is a capital expenditure if it relates to damage to the UOP for which the taxpayer properly had taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165. By retaining the casualty loss rule, the repair regulations do not limit a taxpayer's ability to accelerate the recovery of the basis attributable to such property through the section 165 loss provisions. Rather, they require a taxpayer to capitalize the costs of restoring the property, with recovery of such costs permitted through depreciation.

In certain instances, the property damaged in a casualty event might have remaining basis that is insignificant compared to the costs necessary to restore the property. In this situation, the repair regulations provide an election that permits a taxpayer to forgo the casualty deduction and deduct the cost of the restoration. Specifically, the

repair regulations revise the rules of accounting for property to which section 168 applies and also for determining gain or loss upon the disposition of such property.

The 2008 proposed regulations provided that if an amount paid results in the rebuilding of a UOP to a like-new condition after the end of its economic useful life, then the amount must be capitalized as a restoration of the UOP. The temporary regulations provide that a UOP is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications. Contrary to the 2008 proposed regulations, the repair regulations apply only to amounts paid to rebuild the UOP after the end of the class life of the UOP as defined under sections 168(g)(2) and (3).

Major component or substantial structural part

The repair regulations define a major component or substantial structural part to include "a part or combination of parts that comprise a large portion of the physical structure of the UOP or that perform a discrete and critical function in the operation of the UOP." While maintaining this capitalization requirement, the restoration rules included in the repair regulations depart from the 50-percent thresholds and recovery period limitation in the 2008 proposed regulations.

Instead, as illustrated by the numerous added examples, the repair regulations take a facts-and-circumstances approach as used by the courts, including consideration of the quantitative or qualitative significance of the part or combination of parts in relation to the UOP, building structure, or relevant building system. However, the repair regulations note that the replacement of a minor component of the UOP generally will not constitute a major component or substantial structural part even if such minor component may affect the function of the UOP.

Observation: As the IRS notes in the preamble to the temporary regulations, the 50-percent thresholds would have provided an objective, bright-line alternative to the highly factual analysis applied by the courts and the IRS in determining whether a replacement part was a capital or deductible expenditure. Removal of this objective rule in favor of a facts-and-circumstances-based approach likely will create controversy in future years, as do many issues that involve a subjective, factual determination.

Adaption to a new or different use

In general, the repair regulations maintain the test contained within the 2008 proposed regulations that taxpayers must capitalize amounts that adapt a UOP to a new or different use. An amount is paid to adapt a UOP to a new or different use if the adaptation is inconsistent with the taxpayer's intended, ordinary use of the UOP at the time originally placed in service by the taxpayer. In addition, in the case of a building, the repair regulations provide that an amount is paid to adapt the UOP to a new or different use if it adapts to a new or different use any of the properties listed generally in the temporary regulations (i.e., a building, condominium, cooperative, or leased building).

Observations: As illustrated by the examples in the temporary regulations, a proper determination of whether an amount must be capitalized because it is paid to adapt a UOP to a new or different use will depend on the facts and circumstances. Stated differently, what is a new or different use for one taxpayer may not be a new or different use for another taxpayer.

While the focus of any analysis under the temporary regulations generally should be limited to the specific facts and circumstances at hand, taxpayers likely will consider taking into account any broadly accepted industry norms when evaluating what is considered "ordinary use" of a UOP. Doing so may help the taxpayer better evaluate whether an amount is paid to adapt a UOP to a new or different use.

Routine maintenance safe harbor

The 2008 proposed regulations provided a safe harbor from capitalization for amounts paid to perform certain routine maintenance. The temporary regulations retain this safe harbor with certain modifications. Under the safe harbor, amounts paid for routine maintenance on a UOP, other than a building or a structural component of a building, are deemed not to improve that UOP.

Routine maintenance is defined as recurring activities to a UOP, other than a building or a structural component of a building, that a taxpayer expects to perform as a result of the taxpayer's use of the UOP in order to keep (as opposed to put) the UOP in its ordinarily efficient operating condition. Such activities are considered routine only if, at the time the UOP is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life of the UOP. Factors to be considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its AFS.

Routine maintenance does not include amounts paid:

- For the replacement of a component of a UOP and the taxpayer has properly deducted a loss for that component (other than a casualty loss),
- For the replacement of a component of a UOP and the taxpayer has
 properly taken into account the adjusted basis of the component in
 realizing gain or loss resulting from the sale or exchange of the
 component,
- For the repair of damage to a UOP for which the taxpayer has taken a basis adjustment as a result of a casualty loss, or relating to a casualty event, and
- To return a UOP to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use.

Observation: The exclusion of buildings from the routine maintenance safe harbor is a significant modification from the 2008 proposed regulations. The IRS notes in the preamble to the temporary regulations that buildings were excluded from the safe harbor because the government concluded that the application of the safe harbor to buildings could have resulted in the deduction of many remodeling projects normally thought of as capital (e.g., replacement of a roof). A further change from the 2008 proposed regulations provides that amounts paid for routine maintenance can include amounts paid for routine maintenance performed on (and with regard to) certain rotable and temporary spare parts.

Regulatory Accounting Method

The temporary regulations allow taxpayers that are subject to the regulatory accounting rules of the Federal Energy Regulatory Commission, the Federal Communications Commission, or the Surface Transportation Board to follow their

methods of accounting for regulatory accounting purposes in determining whether amounts improve property under section 263(a).

Thus, for example, taxpayers using the "regulatory accounting method" may not use the routine maintenance safe harbor provided by the temporary regulations. Instead, such taxpayers must capitalize (or not capitalize) for Federal income tax purposes amounts that they capitalize (or do not capitalize) for regulatory accounting purposes. However, section 263A continues to apply to costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

Observation: A taxpayer using the regulatory accounting method must use it for all its tangible property subject to regulatory accounting rules. The method does not apply to property for the tax years in which the taxpayer elected to apply the repair allowance under Reg. sec. 1.167(a)-11(d)(2).

Optional Repair Allowance

The 2006 proposed regulations reinstated the repair allowance concept from the class life asset depreciation range system. However, comments on both the 2006 and 2008 proposed regulations objected to a "one-size fits all" repair allowance method. The temporary regulations provide that the IRS will release future guidance, likely industry specific, that taxpayers can use to implement a repair allowance.

The IRS already has published guidance on the repair allowance method for wireless and wireline network assets (Rev. Proc. 2011-28 and Rev. Proc. 2011-27, respectively) and electric transmission and distribution equipment (Rev. Proc. 2011-43). An industry issue resolution (IIR) also is expected to provide a repair allowance method for the natural gas and cable television industries as well as electric generation assets.

For more information, please do not hesitate to contact:		
George Manousos	(202)414-4317	george.manousos@us.pwc.com
Bob Love	(414) 212-1723	robert.love@us.pwc.com
Devin Hall	(713) 356-5212	devin.c.hall@us.pwc.com
David Crawford	(202) 414-1039	david.l.crawford@us.pwc.com
James Liechty	(202) 414-1694	james.f.liechty@us.pwc.com
Sara Logan	(202) 414-1417	sara.l.logan@us.pwc.com

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

 $\frac{\text{http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=393301\&sessionid=1\&key=5F824A9363C2819ABC45DCC72485E6EA}{\text{http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=393301\&sessionid=1\&key=5F824A9363C2819ABC45DCC72485E6EA}{\text{http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=393301\&sessionid=1&key=5F824A9363C2819ABC45DCC72485E6EA}{\text{http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=393301\&sessionid=1&key=5F824A9363C2819ABC45DCC72485E6EA}{\text{http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=393301&sessionid=1&key=5F824A9363C2819ABC45DCC72485E6EA}{\text{http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=393301&sessionid=1&key=5F824A9363C2819ABC45DCC72485E6EA}{\text{http://event.on24.com/eventRegistration/prereg/register.jsp.}}$

Link to WNTS Insight archive: http://www.pwc.com/us/en/washington-national-tax-services-insight-archives.jhtml

PwC WNTS Insight 11

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

^{© 2012} PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.