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Capitalizing on the Repair Regulations

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The Department of the Treasury finalized new regulations in 2013 and 2014 that will dramatically affect the income taxation of property owners and other businesses. The regulations, commonly known as the Tangible Property Regulations or the Repair Regulations, were the culmination of nearly a decade of government effort to reduce confusion (and litigation) over what expenses may be immediately deducted and what must be capitalized and depreciated over time. This article will address a few noteworthy changes that affect owners of real property.

A taxpayer may deduct all of its ordinary and necessary business expenses paid or incurred in its trade or business under Internal Revenue Code Section 162, including repairs to the taxpayer's properties. However, Code Section 263(a) provides that no deduction is allowed for amounts paid out for "new buildings or for permanent improvements or betterments made to increase the value of any property" and "any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."

The expenses covered by Section 263(a) are capitalized as a new asset for income tax purposes and generate depreciation deductions over time. The de-

termination of whether an expense may be deducted as a repair under Section 162 or must be capitalized as an improvement under Section 263(a) has been the subject of much litigation. The new regulations provide a detailed framework for delineating the boundary between repairs and capitalized improvements.

"Significant Portion"

Under the regulations, a taxpayer must divide its assets into "units of property," which are further subdivided into "major components." A "unit of property" is typically a single building, and a "major component" is defined as a part or combination of parts that perform a discrete and critical function in the operation of the unit of property. A taxpayer may generally immediately deduct an expense if it does not replace a "significant portion" of a major component of a unit of property. In contrast, the taxpayer must capitalize the expense if it does replace a significant portion. The examples in the regulations suggest that more than 30 or 40 percent of a component is considered a significant portion of the component.

For example, assume that a taxpayer owns a large office building with 300 windows. The office building is considered a "unit of property," and the windows are a "major component" of the office building. If the taxpayer replaces 200 windows, the taxpayer is replacing a significant portion of the window major

component, and the taxpayer must capitalize the cost of the 200 windows. The taxpayer may choose, but is not required to, deduct the remaining basis of the 200 old windows being replaced.¹

In contrast, if the taxpayer replaces only 100 windows, the taxpayer is not replacing a significant portion of the window major component, and the taxpayer may immediately deduct the cost of all 100 windows. The tax basis of the 100 old windows would continue to be depreciated by the taxpayer as before over 39 years.

Depending on the relative size of the overall property, a taxpayer under the new regulations may deduct substantial expenses that previously may have had to be capitalized. For example, assume that a taxpayer has a 10-story building, and the taxpayer decides to replace the floors in the lobby. All of the building's floors constitute a major component of the building, and the taxpayer is improving only 10% of the major component. The taxpayer may deduct the lobby floor renovations because the taxpayer is not replacing a significant portion of the floor major component.

Similarly, the taxpayer may deduct tenant improvement renovations to one or two floor levels of its 10-story building when a new tenant moves in, as long as the renovations do not adapt the space to a "new or different use" under an exception described below, because the tenant improvement renovations are not being applied to a significant portion of a major component of the building. In

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contrast, if the taxpayer is renovating four or more levels, the renovation expenses may be significant enough to require capitalization.

While the regulations provide that each building is a unit of property, various structural parts of a building are considered separate units of property: (i) the heating, ventilation, and air conditioning (HVAC) systems, (ii) the plumbing systems, (iii) the electrical systems, (iv) all escalators, (v) all elevators, (vi) the fire protection and alarm systems, (vii) the security systems, (viii) the gas distribution systems, and (ix) other structural components identified in future regulations.

For example, assume that a taxpayer's building has a HVAC system that consists of three furnaces, three air conditioning units, one chiller unit, and extensive duct work. The HVAC system is a separate unit of property, and the significance of any HVAC expenses is tested by reference to only the rest of the HVAC system. The taxpayer may deduct the cost of replacing a single furnace, because a single furnace is not a significant portion of the furnace major component of the HVAC system. The taxpayer must capitalize the cost of replacing the chiller unit, since the sole chiller unit is all of a major component of the HVAC system.

Exceptions

The regulations contain caveats and other exceptions that require capitalization in many cases, which should be

studied in detail by interested taxpayers. For instance, a taxpayer must capitalize an expense if it is restoring a unit of property (e.g., an entire HVAC system) that had deteriorated to a state of disrepair and no longer functioned for its intended use. A taxpayer must capitalize an expense if it is paid to adapt a unit of property to a new or different use, i.e., the adaptation is not consistent with the taxpayer's ordinary use of the property. A taxpayer must capitalize an expense if it relates to a unit of property for which the taxpayer claimed a casualty loss under Section 165, such as due to a fire or a flood.

Further, a taxpayer must capitalize an expense if it is for a betterment of a unit of property, which includes an amelioration of a preexisting defect in an acquired property, a physical enlargement of a building, or an increase in the efficiency of a building system.² If an improvement replaces a "substantial structural part" of a unit of property, the improvement must be capitalized even if it is not considered a significant portion of a major component of a unit of property.

An important change in the new rules is the taxpayer's optional ability to deduct the remaining basis of its old replaced assets if the taxpayer is capitalizing the new assets. Before the enactment of the new regulations, a taxpayer may have been required to have multiple generations of the same asset on its tax return being depreciated at the same time, such as multiple roofs being depreciated

over overlapping 39 year recovery periods. Under the new regulations, the taxpayer can always deduct the remaining basis of its old roof(s) when it capitalizes the cost of a newly installed roof (as a major component of the building). As a result, even if a taxpayer is undergoing major projects that must all be capitalized, the new regulations allow newly accelerated deductions for the taxpayer's old assets.

Conclusion

The rules described above are only a small part of the Tangible Property Regulations, which also introduced new rules for deducting the costs of materials and supplies, de minimis safe harbors for small expenses, enhanced deductions for routine maintenance activities, changes to general asset accounts and other conventions, and numerous other industry-specific issues and examples. The new regulations are generally effective for taxable years after January 1, 2014. Many taxpayers with pre-existing property may have to change their methods of accounting to conform to the new regulations, which may allow them to claim significant tax deductions for assets capitalized in prior years.

¹ If the taxpayer does not know the separate tax basis of the replaced asset, the regulations contain several methods on how to allocate tax basis to the replaced asset.

² If a part cannot be reasonably replaced with the same part due to technological advancement or product enhancements, the part's replacement with an improved, but comparable, part is not a betterment of the property.

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