

# COMPREHENSIVE REPAIR/ CAPITALIZATION REGULATIONS

August 21, 2012

*Special Report*

## HIGHLIGHTS

- Guidance For Treatment Of Materials And Supplies
- Regs On Tangible Property
- De Minimis Expensing Rule
- Accounting For MACRS Property
- Dispositions Of MACRS Property
- MACRS General Asset Accounts
- 2012 Effective Dates And Deadlines

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## Repair Regulations Have Sweeping Impact; Will Require Accounting Method Changes

**M**ore than six months after the IRS issued temporary “repair” regulations (T.D. 9564), many complex questions remain about their interpretation and application. One thing is for sure however; they affect all businesses in one way or another. Accordingly, it is vital to become intimately familiar with their content to understand how each client is affected.

**IMPACT:** *The new regulations are generally effective for tax years beginning on or after January 1, 2012. However, certain portions are effective for amounts paid or incurred in tax years beginning on or after January 2, 2012, a subtle but important difference. To complicate matters further, the regulations are, in effect, retroactive insofar as an accounting method change will need to be filed in many cases and adjustments made to reflect these prior years.*

The IRS initially reported it wants to make as few substantive changes as possible when it issues final regulations. However, the regulations have been subject to much criticism over the past several months because they often rely on facts-and-circumstances tests in distinguishing repairs from capitalized expenses. This is the approach that caused conflicts between the IRS and taxpayers in the first place. As a result, the IRS is under pressure to further simplify the regulations with additional bright-line tests and safe-harbors. How the IRS responds to this pressure remains to be seen.

**IMPACT:** *In March 2012, the IRS instructed its examiners to “stand down” on audits of capitalization issues for pre-2012 tax years (LB&I Field Directive 4-0312-004). The stand-down is for a two-year period and will give taxpayers a limited opportunity to change their accounting methods to comply with the regulations without risking the negative consequences of an audit.*

The repair regulations also include some important Modified Accelerated Cost Recovery System (MACRS) changes. These MACRS regulations are also effective for tax years beginning on or after January 1, 2012. The IRS issued Rev. Proc. 2012-20 to cover all automatic accounting method changes associated with the MACRS regulations. Rev. Proc. 2012-19 covers automatic changes relating to the regulations dealing with capitalization issues.

The chief take-away of the MACRS temporary regulations is that the retirement of a structural component on an MACRS building is now treated as a disposition that results in a loss deduction equal to the adjusted depreciable basis (i.e., the undepreciated basis) of the structural component.

**IMPACT:** *Taxpayers that previously retired a structural component which is currently being depreciated will need to change accounting methods to bring the treatment of the structural component into compliance with the new rules. As explained in this briefing, for most taxpayers the change in method will involve making a retroactive MACRS general*

*asset account election and then deciding whether to claim a loss on the retired component through a Code Sec. 481(a) adjustment or to continue to depreciate the retired component.*

## TEMPORARY REGULATIONS BY SUBJECT

The key temporary “repair” regulations, in the order followed by this briefing, are summarized as follows:

- **Materials and supplies—Temp. Reg. §1.162-3T.** This regulation provides a definition of materials and supplies, explains the proper tax year for deduction, allows an election to capitalize materials and supplies, and contains special rules for rotatable spare parts.
- **De minimis expensing rule—Temp. Reg. §1.263(a)-2T(g)** Taxpayers with an “applicable financial statement,” such as a certified audited financial statement, may claim a current deduction for the cost of acquiring items of relatively low-cost property, including materials and supplies, if specific requirements are met. The aggregate cost which may be expensed annually under a taxpayer’s expensing policy is subject to a ceiling equal to the greater of .1 percent of gross receipts or 2 percent of total depreciation and amortization reported on the financial statement.
- **Amounts paid to acquire or produce tangible property—Temp. Reg. §1.263(a)-2T.** This portion of the regulations explains which costs associated with the acquisition or production of real or personal property must be capitalized to the basis of the property and which costs may be claimed as a current deduction.
- **Amounts paid to improve tangible property—Temp. Reg. §1.263(a)-3T.** This is the “main course” of the temporary regulations which provides rules for distinguishing repairs from capital expenditures. Capital expenditures are divided into three categories of improvements: betterments, restorations,

and adaptations. Generally, whether an expenditure is an improvement is based on facts and circumstances. A safe harbor is provided for routine maintenance activities. Also, certain regulated taxpayers may elect to use their regulatory accounting method to distinguish between repairs and capital expenditures.

- **Unit of property defined—Temp. Reg. §1.263(a)-3T(e).** The “unit of property” is a critical concept in determining whether an expenditure is a repair

“The temporary regulations affect all taxpayers that acquire, produce, or improve tangible property, and are effective for tax years (or costs incurred in taxable years, as appropriate) beginning on or after January 1, 2012.”

or capital expenditure. An expenditure on a large unit of property is more likely to be considered a repair expense. The regulation contains detailed rules for determining the size of a unit of property in the case of buildings and other types of property.

- **MACRS temporary regulations.** The repair regulations include several topics issued under Code Sec. 168 relating to the modified accelerated cost recovery depreciation system (MACRS). Although not obvious at first blush, certain parts of these regulations have a direct connection to the repair v. capitalization issue.
- **Dispositions of MACRS property—Temp. Reg. §1.168-8T.** Rules are also provided for determining gain or loss upon the disposition of MACRS

property. Key provisions of the regulation treat the retirement of a structural component as a loss deduction and define an “asset” that is considered disposed of. Taxpayers are allowed to use a reasonable and consistent method to treat components of a structural component as an asset and, therefore, recognize loss upon the disposition of a portion of a structural component. A similar rule applies to most section 1245 property.

- **MACRS general asset accounts—Temp. Reg. Reg. §1.168-1T.** The existing MACRS general asset account (GAA) regulations are updated and revised. Most importantly, an election to recognize gain or loss by reference to the adjusted basis of an asset disposed of from a GAA now applies to virtually any asset disposed of. Previously, a taxpayer was usually required to recognize the entire amount realized upon a disposition as ordinary income and no loss deduction was allowed.

**IMPACT:** *A taxpayer may place an asset, such as a building, in a GAA and whenever an asset, such as a structural component, is retired choose whether to follow the GAA default rule that no loss is recognized or elect to recognize a loss equal to the adjusted depreciable basis of the asset.*

- **Accounting for MACRS property in single/multiple asset accounts—Temp. Reg. Reg. §1.168-7T.** This regulation provides rules for depreciating an item of MACRS property separately (i.e., in a single item account) or a group of items of MACRS property as a single asset in multiple asset or “pool” account. The IRS has not updated the rules for item and pool accounts since prior to the enactment of the accelerated cost recovery system (ACRS) for pre-1981 assets. Essentially, this regulation is simply attached as a “rider” to the repair regulations and is unrelated to the capitalization v. repair issue. However, since many taxpayers account for depreciable assets in pool accounts, it is important to become familiar with these rules.
- **Automatic accounting method changes—Rev. Procs. 2012-19, 20.** Automatic

procedures for changing accounting methods to the methods required or allowed in the temporary regulations are provided in Rev. Procs. 2012-19 and 2012-20. These procedures are discussed in detail in the last section of this briefing.

## MATERIALS AND SUPPLIES

The material and supply regulations (Temp. Reg. §1.162-3T):

- Define materials and supplies;
- Provide rules regarding the tax year for deducting materials and supplies;
- Provide an election to treat certain materials and supplies as deductible expenses in the year paid or incurred under a de minimis rule;
- Allow a taxpayer to elect to capitalize certain materials and supplies;
- Treat a rotatable or temporary spare part as deductible in the tax year in which a taxpayer disposes of the rotatable or temporary part; and
- Provide an optional method of accounting for rotatable and temporary spare parts that allows deduction upon initial installation.

**IMPACT:** *The temporary regulations for materials and supplies basically formalize existing rules which had never been set down in regulations. Of particular significance, however, is the addition of a definition of materials and supplies and specific rules for rotatable spare parts.*

### Materials and Supplies Defined

A material and supply is defined to mean tangible property used or consumed in the taxpayer's business operations that is not inventory and that is (Temp. Reg. §1.162-3T(c)):

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

- A unit of property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;
- A unit of property that has an acquisition cost or production cost of \$100 or less (the \$100 limit may be increased by the IRS); and
- Property identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as materials and supplies.

The cost of nonincidental materials and supplies are deducted in the year used or consumed (Temp. Reg. §1.162-3T(a)(1)).

Incidental materials and supplies are materials and supplies that are carried on hand and for which no record of consumption is kept or for which physical inventories at the beginning and end of the tax year are not taken. Incidental materials and supplies are deductible in the tax year their cost is paid or incurred (Temp. Reg. §1.162-3T(a)(2)).

**EXAMPLE:** *A calendar-year taxpayer purchases a building window in 2012 and replaces a broken window in 2013. The window is a component used to repair a unit of tangible property (the building structure) and is deductible as a material or supply in 2013 when used, provided no retirement loss deduction is claimed for the undepreciated cost of the retired window.*

**CAUTION:** *As explained below, the cost of replacing a component on a unit of property cannot be deducted as a repair or as a material or supply if a retirement loss is claimed on the replaced component (Temp. Reg. Sec. 1.263(a)-3T(i)).*

### Rotatable Parts

A rotatable spare part is a component of a unit of property which is installed on the property, removed from the property, repaired or improved, and either reinstalled on the same or other property or stored for later installation. Temporary spare parts are components used temporarily until a new or repaired part can be installed and then

are removed and stored for later (emergency or temporary) installation (Temp. Reg. §1.162-3T(c)(2)).

Rotatable and temporary spare parts are considered used or consumed in the tax year in which the parts are disposed of. Therefore, they are deducted in the disposition year (Temp. Reg. §1.162-3T(a)(3)). However, the deduction is claimed in the year of installation if the taxpayer uses the optional method for accounting for rotatable and temporary spare parts.

If the optional method for rotatable spare parts is used a deduction for the amount paid or incurred to acquire or produce the rotatable is claimed in the tax year that the rotatable is first installed. The taxpayer includes in income and assigns a cost basis equal to the fair market value of the used, non-functioning part, and capitalizes the costs of repairing the part. If the repaired part is later used as a replacement part in the taxpayer's equipment, the taxpayer deducts the basis of the part in the tax year it is re-installed. This cycle continues until disposition of the part (Temp. Reg. §1.162-8T(e)).

**PLANNING NOTE:** *A taxpayer that uses the optional method of accounting for rotatables must use the method for all of its rotatable and temporary spare parts in the same trade or business.*

**COMMENT:** *No formal election is required to use the optional method.*

### Election to Capitalize Materials and Supplies

A taxpayer may elect to capitalize the cost of a material or supply in the tax year the cost is paid or incurred and depreciate the cost in the tax year it is placed in service (Temp. Reg. §1.162-3T(d)). Any asset for which the election is made is not treated as a material or supply.

**IMPACT:** *This election would be particularly useful to taxpayers who may be unsure of the proper tax year of deduction because they are unable to distinguish between incidental and non-incidental supplies or*

*do not maintain detailed records regarding their purchases and the tax year in which they are used or consumed.*

**CAUTION:** *The election does not apply to a component of a material or supply unless the capitalization election is made for the entire material of supply. The election does not apply to rotatable parts if the optional method is used.*

A taxpayer makes the election to capitalize the cost of a material and supply by capitalizing the cost in the tax year the cost is paid or incurred and by depreciating the cost when the material and supply is placed in service. The election is made on a taxpayer's timely filed original Federal income tax return (including extensions) for the tax year the asset is placed in service for purposes of determining depreciation.

### **Election to Apply de Minimis Rule to Materials and Supplies**

A taxpayer may elect to apply the de minimis rule of Temp. Reg. §1.263(a)-2T(g), discussed below, to any portion of its materials and supplies and claim a deduction in the year the cost of materials or supplies are paid or incurred (Temp. Reg. §1.162-3T(f)).

**IMPACT:** *Under the general rule, materials and supplies are usually deducted in the tax year used or consumed. The election to deduct materials and supplies under the de minimis rule is beneficial if the tax year that the cost of the materials and supplies is paid or incurred occurs before the tax year of use or consumption.*

### **Effective Date**

The repair regulations are generally effective for tax years beginning on or after January 1, 2012. The material and supply regulations (Temp. Reg. §1.162-3T), however, apply to amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012. One exception: a taxpayer may elect to apply the

optional method of accounting for rotatable spare parts to tax years beginning on or after January 1, 2012, and take advantage of a Code Sec. 481(a) adjustment attributable to rotatables acquired before January 1, 2012 (Temp. Reg. §1.162-3T(i)).

### **Accounting Method Changes**

Rev. Proc. 2012-19 adds the following automatic accounting method changes relating to materials and supplies to the Appendix of Rev. Proc. 2011-14:

- (1) Change to comply with definition of non-incidentals materials and supplies and deduct in year used or consumed (Section 3.12) (cut-off method applies);
- (2) Change to comply with definition of incidentals materials and supplies and deduct in year paid or incurred (Sec. 3.13) (cut-off method applies);
- (3) Change to deduct cost of non-incidentals rotatable spare parts in tax year of disposition (Sec. 3.14) (cut-off method applies); and
- (4) Change to optional method of accounting for rotatable spare parts (Sec. 3.15).

**COMMENT:** *It appears that Section 3.15 inadvertently fails to apply the change to the optional method for rotatables on a cut-off basis insofar as the provision applies to amounts paid or incurred in tax years beginning on or after January 1, 2012. A cut-off method should apply unless the election is made to apply the optional method to tax years beginning on or after January 1, 2012.*

### **DE MINIMIS EXPENSING RULE**

A new de minimis expensing rule allows a taxpayer to deduct certain amounts paid or incurred to acquire or produce a unit of tangible property if the taxpayer has an Applicable Financial Statement (AFS), written accounting procedures for expensing amounts paid or incurred for such property under certain dollar amounts, and treats such amounts as expenses on its AFS in accordance with its written accounting pro-

cedures. An overall ceiling limits the total expenses that a taxpayer may deduct under the de minimis rule (Temp. Reg. §1.263(a)-2T(g)). The de minimis expensing rule applies to amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012 (Temp. Reg. 1.263(a)-2T(k)).

**IMPACT:** *The de minimis rule is one of the most important provisions of the temporary repair regulations. Previously, expensing policies were not governed by any specific rules or requirements other than that the policy not materially distort income. Going forward, a taxpayer will need to comply with strict regulatory requirements in order to take advantage of an expensing policy.*

**IMPACT:** *Many small businesses do not have applicable financial statements and will not be able to use the de minimis rule unless the IRS approves additional types of financial statements in the final regulations. These taxpayers will be limited to expensing amounts that qualify under Code Sec. 179.*

**CAUTION:** *Speakers at the May 9, 2012 IRS public hearing on the new rules criticized the regs as being impractical and burdensome for both large and small businesses. One speaker suggested that a "major rethink" by the IRS is needed on certain provisions, singling out the de minimis rule as having caused much confusion.*

Materials and supplies are subject to the de minimis rule to the extent that a taxpayer elects to treat them as subject to the rule (Temp. Reg. §1.162-3T(f)).

**COMMENT:** *Incidental materials and supplies are deducted in the tax year that their cost is paid or incurred. Consequently, there is no reason to elect to apply the de minimis rule to these materials and supplies. Non-incidentals materials and supplies are deducted when used or consumed. The de minimis rule is beneficial for non-incidentals*

*materials and supplies that would be used or consumed in a tax year after their cost is paid or acquired.*

If property expensed under the de minimis rule is sold or disposed of, the amount recognized is ordinary income. The property is not treated as a capital asset or as property used in a trade or business under Code Sec. 1231.

With the exception of materials and supplies for which the de minimis rule is elected, the de minimis rule applies to amounts that must otherwise be capitalized because the amount was paid to acquire or produce a unit of real or personal property. Amounts paid to acquire or produce a unit of property include the invoice price, certain transactions costs such as transportation costs, and costs for work performed prior to the date the unit of property was placed in service such as installation, critical testing, and repair costs (Temp. Reg. §1.263(a)-2T(d)). Amounts paid for property intended for use in inventory may not be deducted under the de minimis rule.

The de minimis rule applies if:

- (1) The taxpayer has an applicable financial statement;
- (2) The taxpayer has at the beginning of the tax year written accounting procedures treating as an expense for non-tax purposes the amounts paid or incurred for property costing less than a certain dollar amount;
- (3) The taxpayer treats the amounts paid or incurred during the tax year as an expense on its applicable financial statement in accordance with its written accounting procedures; and
- (4) The total aggregate of amounts paid or incurred and not capitalized under the de minimis rule (including materials and supplies for which an election is made to apply the de minimis rule) are less than or equal to the greater of—
  - (a) 0.1 percent of the taxpayer's gross receipts for the tax year as determined for Federal income tax purposes; or
  - (b) 2 percent of the taxpayer's total depreciation and amortization ex-

pense for the tax year as determined in its applicable financial statement.

**COMMENT:** *The preamble to the regulations (T.D. 9564) indicates that the cap may be increased if an examining agent agrees that the increase is not material. Thus, it appears that taxpayers with an expensing policy previously approved in an audit may continue to expense amounts in excess of the cap so long it does not result in a material distortion of income.*

“The de minimis rule is one of the most important provisions of the temporary repair regs”

**COMMENT:** *The IRS has indicated that if a taxpayer inadvertently deducts more than the amount allowed under the de minimis rule only the excess amount will be disallowed as a current deduction. The final regulations should clarify this point.*

**EXAMPLE:** *YAZ purchases 10 printers at \$200 each for a total cost of \$2,000. Each printer is a unit of property and is not a material or supply. YAZ has an applicable financial statement and a written policy at the beginning of the tax year to expense amounts paid for property costing less than \$500. YAZ treats the amounts paid for the printers as an expense on its applicable financial statement. Assume that the total aggregate amount treated as de minimis and not capitalized, including the amounts paid for the printers, are less than or equal to the greater of 0.1 percent of total gross receipts or 2 percent of YAZ's total financial statement depreciation. The de minimis rule applies and YAZ is not required to capitalize the amounts paid for the 10 printers (Temp. Reg. §1.263(a)-2T(g)(9), Ex. 1).*

**CAUTION:** *Taxpayers that did not have a written policy of expensing de minimis*

*amounts in effect on January 1, 2012 (or the first day of their 2012 tax year) may not use the de minimis rule during 2012. Because the temporary regulations were issued in December 2011 some taxpayers had insufficient time to put a written policy in effect. Commentators have asked for transitional relief from this requirement.*

**IMPACT:** *Amounts expensed under the de minimis rule are not required to be capitalized under the uniform capitalization rules of Code Sec. 263A to a separate unit of property but may be required to be capitalized under Code Sec. 263A as part of the cost of other property if incurred by reason of the production of the other property. For example, taxpayers are required to capitalize under Code Sec. 263A the cost of tools and equipment allocable to property produced or property acquired for resale.*

The de minimis rule is not elective. However, a taxpayer may elect to capitalize amounts that would otherwise be subject to the de minimis rule. The election is simply made by capitalizing the amounts paid or incurred to acquire or produce the unit of property in the tax year the cost is paid or incurred. (Temp. Reg. §1.263(a)-2T(g)(4)). A taxpayer should capitalize amounts that would be deductible under the de minimis rule but for the ceiling.

### Applicable Financial Statement

An applicable financial statement for purposes of qualifying for the de minimis rule only includes:

- (1) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);
- (2) A certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for (a) credit purposes, (b) reporting to shareholders, partners, or similar persons, or (c) any other substantial non-tax purpose; or

- (3) A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the Internal Revenue Service).

### Accounting Method Change

An automatic change in accounting method procedure may be used to adopt the de minimis expensing method. The change is applied on a cut-off basis (Rev. Proc. 2012-19, adding Section 3.17 to the Appendix of Rev. Proc. 2011-14).

## AMOUNTS PAID TO ACQUIRE OR PRODUCE TANGIBLE PROPERTY

Although not related to the “repair v. capitalization” issue, the temporary regulations include rules explaining the types of costs that must be capitalized as amounts paid to acquire or produce a unit of tangible property (Temp. Reg. §1.263(a)-2T). The de minimis rule is included in these temporary regulations (Temp. Reg. §1.263(a)-2T(g)) but is discussed above separately on account of its special importance.

The temporary regulations relating to amounts paid to acquire or produce a unit of property are generally effective for tax years beginning on or after January 1, 2012 (Temp. Reg. §1.263(a)-2T(k)).

A taxpayer must capitalize amounts paid or incurred to acquire or produce a “unit” of real or personal property, including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. The term “produce” is defined in the same way as for purposes of the uniform capitalization rules. Amounts paid or incurred to acquire or produce a unit of property include (Temp. Reg. §1.263(a)-2T(d)(1)):

- Invoice price;
- Transaction costs; and

- Costs for work performed prior to the actual date that the unit of property is placed in service

**COMMENT:** *The placed-in-service date is the actual date the property is placed in service and not the date placed in service under the applicable MACRS depreciation convention.*

**CAUTION:** *Taxpayers subject to the uniform capitalization rules of Code Sec. 263A must also capitalize direct and indirect costs to produced property and property acquired for resale.*

### Work Prior to Placing Property in Service

Capitalized costs paid to acquire or produce a unit of real or personal property include the costs for work performed prior to the date that the unit of property is placed in service. Work performed includes, for example, repairs, installation costs, and testing costs (Temp. Reg. 1.263(a)-2T(d)(1)).

### Capitalized Amounts Recovered Through Depreciation or Inclusion in Inventory

Amounts paid or incurred to acquire or produce tangible property that are required to be capitalized must be taken into account through a charge to capital account or basis, or in the case of property that is inventory in the hands of a taxpayer, through inclusion in inventory costs. Code Sec. 263A, however, governs the treatment of direct and certain indirect costs of producing property or acquiring property for resale.

Amounts that are capitalized are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable provisions of the Internal Revenue Code and regulations relating to the use, sale, or disposition of property (Temp. Reg. §1.263(a)-2T(h) and (i)).

### Defending or Perfecting Title

Amounts paid or incurred to defend or perfect title to real or personal property are capitalized (Temp. Reg. §1.263(a)-2T(e)(1)). For example, amounts paid or incurred with respect to an attorney to contest the condemnation of a portion of real property for use as a roadway or to challenge a building line established by a municipality across a property that adversely affects its value are incurred to defend title and must be capitalized (Temp. Reg. §1.263(a)-2T(e)(2), Exs. 1 and 3). On the other hand the cost of a suit against a municipality that prohibits the operation of an existing business is not incurred to defend title but rather to preserve the business. Such costs, however, may need to be capitalized under the uniform capitalization rules as direct or allocable indirect costs of property produced or acquired for resale (Temp. Reg. §1.263(a)-2T(e)(2), Ex. 2).

### Facilitative Acquisition Costs

If an amount, based on all the facts and circumstances, is paid or incurred in the process of investigating or otherwise pursuing the acquisition or production of real or personal property such amount is considered paid or incurred to facilitate the acquisition and is a capitalized transaction cost that is included in the basis of the property acquired or produced (Temp. Reg. §1.263(a)-2T(f)(1)).

An amount is paid or incurred to facilitate the acquisition of real or personal property if the amount is paid or incurred in the process of investigating or otherwise pursuing the acquisition. Whether an amount is paid or incurred in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. The fact that the amount would (or would not) have been paid or incurred but for the acquisition is relevant but is not determinative (Temp. Reg. §1.263(a)-2T(f)(2)(i)).

The following examples describe costs that are “inherently facilitative” and, therefore, must be capitalized (Temp. Reg. §1.263(a)-2T(f)(2)(ii)):

- 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 or incurred 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 qualified intermediary or other facilitator of a Code Sec. 1031 like-kind exchange.

**Facilitative amounts for unacquired property.** Inherently facilitative amounts are capitalized even if the real or personal property is not ultimately acquired or produced. Inherently facilitative amounts allocable to real and personal property not acquired *may be* allocated to those properties and recovered as appropriate (for example, as a loss under Code Sec. 165 or depreciation under Code Sec. 167 or Code Sec. 168) (Temp. Reg. §1.263(a)-2T(f)(3)(ii)).

**COMMENT:** *The temporary regulations do not require the allocation of inherently facilitative amounts to properties that are not acquired. Taxpayers may allocate these amounts to the property which is actually acquired in accordance with the rule which was followed prior to the temporary regulations (United Dairy Farmers, Inc., CA-6,*

*2001-2 USTC ¶50,680, 267 F.3d 510; Nicolazzi v. Commissioner, 79 T.C. 109, Dec. 39,200; aff'd, CA-6, 83-2 USTC ¶83-2 USTC ¶9743, 722 F.2d 324).*

**COMMENT:** *The temporary regulations relating to facilitative amounts for unacquired real or personal property are effective for amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012 (Temp. Reg. §1.263(a)-2T(k)).*

“The rule treating the retirement of a structural component as a loss disposition is applied retroactively.”

### Pre-Decisional Costs for Real Property Are Deductible

An amount paid or incurred in the process of investigating or otherwise pursuing the acquisition of real property and which is not an inherently facilitative amount as defined above does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire. Such pre-decisional costs are deductible in the case of real property. If personal and real property are acquired in the same transaction, a taxpayer may use a reasonable allocation method to allocate, between the personal property and real property, the costs of determining whether to enter the acquisition transaction and which property to acquire (Temp. Reg. §1.263(a)-2T(f)(2)(iii)).

**COMMENT:** *This rule is also effective for amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012 (Temp. Reg. §1.263(a)-2T(k)).*

**COMMENT:** *The rule allowing the deduction of investigation costs is intended*

*to eliminate the issue of whether the investigatory costs are deductible business expansion costs or capital expenditures to acquire a specific asset.*

### Employee Compensation and Overhead Costs

Amounts paid or incurred for employee compensation and overhead do not facilitate the acquisition of real or personal property. However, Code Sec. 263A may require employee compensation and overhead costs to be capitalized to property produced by the taxpayer or to property acquired for resale. A taxpayer may elect to treat amounts paid or incurred for employee compensation or overhead as capitalized amounts that facilitate the acquisition of property. The election to capitalize such costs is made separately for each acquisition and applies to employee compensation or overhead, or both (Temp. Reg. §1.263(a)-2T(f)(2)(iv)).

**COMMENT:** *This rule is effective for amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012 (Temp. Reg. §1.263(a)-2T(k)).*

### Moving and Reinstallation Costs

Amounts paid to move and reinstall a unit of property that has already been placed in service are not required to be capitalized under the rules for acquisition or production of property. But, if the costs of moving and reinstalling a unit of property directly benefit, or are incurred by reason of, an improvement to the unit of property that is moved and reinstalled, such costs are required to be capitalized (Preamble to T.D. 9564).

### Accounting Method Changes

Rev. Proc. 2012-19 adds the followings automatic accounting method changes relating to costs to acquire or produce property to the Appendix of Rev. Proc. 2011-14:

- (1) Change to capitalize amounts paid to acquire or produce property under Reg. Sec. 1.263(a)-2T, including

defense of title and transaction costs (Sec. 10.09)

- (2) Change from capitalizing to deducting amounts incurred to investigate acquisition of real property (Sec. 3.18) (cut-off method applies)
- (3) Change from capitalizing to deducting employee compensation and overhead costs incurred to investigate acquisition of real property (Sec. 3.18) (cut-off method applies)

## AMOUNTS PAID TO IMPROVE TANGIBLE PROPERTY

### Improvements Are Capitalized

The heart of the “repair regulations” --Temp. Reg. §1.263(a)-3T-- provides rules for distinguishing between expenditures that are repairs and expenditures that are capital improvements. The provisions in Temporary Reg. §1.263(a)-3T apply to tax years beginning on or after January 1, 2012 (Temp. Reg. §1.263(a)-3T(p)).

**IMPACT:** *Broadly speaking this portion of the regulations provides a framework that integrates the basic rules and concepts that have been developed over the years in court cases and IRS guidance for distinguishing capital expenditures from currently deductible repairs.*

**CAUTION:** *Bright-line tests are markedly absent. Consequently, facts and circumstances will continue to play an important rule in making this determination.*

The regulations require capitalization of amounts paid to improve a unit of tangible property.

A unit of property is improved if amounts are paid for activities performed after the unit of property is placed in service by the taxpayer resulting in:

- A betterment to the unit of property;
- A restoration of the unit of property; or
- Adaptation of the unit of property

to a new or different use (Temp. Reg. §1.263(a)-3T(d)).

A unit of property consists of a group of functionally interdependent components, such as the parts of a machine, with the machine being treated as a unit of property. In the case of a building, the building is a unit of property except that certain major systems of the building, such as heating, air conditioning, and ventilation (HAVC), plumbing, and electrical, are treated as separate units of property (Temp. Reg. §1.263(a)-3T(e)).

**IMPACT:** *The unit of property concept is discussed in detail, below. Generally, the larger the unit of property is the more likely that work on that property will be considered a deductible repair. For example, if the entire building is the unit of property, then major work on an HVAC system might be a repair. However, if the HVAC system is the unit of property, then that work will probably need to be capitalized.*

### Betterments Are Capitalized Improvements

A capitalized betterment is an expenditure that:

- Ameliorates a material condition or defect that existed prior to the taxpayer’s acquisition of the unit of property whether or not the taxpayer was aware of the condition or defect at the time of acquisition;
- Results in a material addition (for example, physical enlargement, expansion, or extension) to the unit of property; or
- Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property (Temp. Reg. §1.263(a)-3T(h)(1)).

**COMMENT:** *Facts and circumstances taken into account in determining whether an expenditure results in a betterment include but are not limited to, the purpose of the expenditure, the physical nature of the work performed, the effect of the*

*expenditure on the unit of property, and the taxpayer’s treatment of the expenditure on an applicable financial statement.*

**EXAMPLE:** *ABC Corp. purchases a parcel of land (the unit of property) without realizing that the soil was contaminated by leaking underground storage tanks left by a previous owner. ABC’s remediation costs to remove the contaminants result in a capitalized betterment to the land because ABC incurs the costs to ameliorate a material condition or defect that existed prior to its acquisition of the land (Temp. Reg. §1.263(a)-3T(h)(4), Ex 1).*

**Replacement with improved but comparable parts.** The replacement of a part of a unit of property with an improved, but comparable part does not, by itself, result in a betterment to the unit of property if it is not practical to replace the part with the same type of part (for example, because of technological advancements or product enhancements) (Temp. Reg. §1.263(a)-3T(h)(3)(ii)).

**EXAMPLE:** *A taxpayer replaces wooden shingles which are no longer available on the market with comparable asphalt shingles that are somewhat stronger than the wooden shingles. The replacement is not a betterment. However, the replacement with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture and have a 50-year warranty and a Class A fire rating is a betterment (Temp. Reg. §1.263(a)-3T(h)(4), Exs. 14 and 15).*

**Comparisons.** If a particular event triggers an expenditure, the determination of whether the expenditure results in a betterment is made by comparing the condition of the property immediately before the event with the condition of the property immediately after the expenditure (Temp. Reg. §1.263(a)-3T(h)(3)(iii)(A) and (C)).

If the expenditure is made to correct the effects of normal wear and tear to the unit of property (including the amelioration of a condition or defect that resulted from normal wear and tear and existed prior to the



taxpayer's acquisition of the unit of property), the determination of whether an expenditure results in a betterment is made by comparing the condition of the property immediately after the expenditures with the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear. If the taxpayer has not previously corrected the effects of normal wear and tear, the comparison is made to the condition of the property when placed in service by the taxpayer (Temp. Reg. §1.263(a)-3T(h)(3)(iii)(B)).

**EXAMPLE:** *A retail shop owner conducts a "building refresh" every 4 or 5 years. The building refresh consists of replacing and reconfiguring a small number of display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations, moving one wall to accommodate the reconfiguration of tables and racks, repainting, patching holes in walls, replacing damaged floor and ceiling tiles and power washing building exteriors. The refresh is not a betterment because it does not result in material increases in capacity, productivity, efficiency, strength, or quality of the buildings' structures or any building systems as compared to the condition of the buildings' structures and systems after the previous refresh (Temp. Reg. §1.263(a)-3T(h)(4), Example (6)).*

## Restorations Are Capitalized Improvements

The second category of capitalized improvements is restorations. An amount is paid to restore a unit of property if (Temp. Reg. §1.263(a)-3T(i)):

- A component of the unit of property is replaced and a loss is deducted or a gain or loss is realized by selling or exchanging the replaced component;
- A casualty loss resulting in any basis adjustment is claimed on the repaired unit of property;
- The expenditures returns a unit of property to its ordinary efficient operating condition after the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

- The expenditures rebuild a unit of property to a like-new condition after the end of its class life; or
- The expenditures are for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property.

"The IRS ruffled a few feathers by taking the position in the temporary regulations that the cost of restoring a property after a casualty loss is not a deductible repair expense if a casualty loss deduction is claimed (Temp. Reg. §1.263(a)-3T(i)). The IRS rule applies even if the amount of the casualty loss relative to the repair expenditures is small."

**Retirement loss deduction claimed.** A repair deduction may not be claimed to replace a component of a unit of property if a loss deduction is claimed on the replaced component or if the replaced component is sold and gain or loss is realized by reference to the adjusted basis of the component (Temp. Reg. §1.263(a)-3T(i)). The retirement of a component will generate a loss equal to the adjusted depreciable basis of the component (i.e., cost less depreciation claimed) if the component is considered an "asset" (Temp. Reg. §1.168(i)-8T(b)(1)).

The definition of an asset is discussed later but generally a taxpayer may use any reasonable and consistent method to treat a component of a unit of property as an "as-

set." In the case of a building each structural component is treated as an asset. A taxpayer may also use the reasonable and consistent standard to treat components of structural components as assets (Temp. Reg. §1.168(i)-8T(c)(4)).

**EXAMPLE:** *XYZ Corp. owns a walk-in freezer. When several components of the freezer cease to function, XYZ abandons them and recognizes a loss equal to the adjusted depreciable basis of the components because it properly treats the components as assets. XYZ then spends \$2,500 to purchase and install new components. Since XYZ replaces components it properly deducted as a loss, it must capitalize the \$2,500 replacement cost. The result is the same if XYZ sells the used components at a gain or loss (Temp. Reg. §1.263(a)-3T(i)(5), Exs. (1) and (2)).*

**COMMENT:** *If the freezer was placed in a MACRS general asset account (GAA), XYZ could choose not to recognize the loss. XYZ could then claim a repair deduction if the expenditures did not have to be capitalized for a reason other than claiming a loss deduction. The rules applicable to GAAs are discussed below.*

**COMMENT:** *If XYZ claims a loss deduction it may compute the basis of the replaced components using any reasonable method, including statistical sampling techniques.*

**Casualty losses.** The IRS ruffled a few feathers by taking the position in the temporary regulations that the cost of restoring property after a casualty loss is not a deductible repair expense if a casualty loss deduction is claimed (Temp. Reg. §1.263(a)-3T(i)). The rule applies even if the amount of the casualty loss relative to the repair expenditures is small. This is possible because casualty losses are generally limited to the lesser of the decline in fair market value of the damaged property or the undepreciated basis of the damaged property (Reg. §1.165-7(b)).

**IMPACT:** A taxpayer is not required to recognize a casualty loss if the property is placed in an MACRS general asset account. Thus, by placing an asset (for example, a building) in a GAA a taxpayer could elect to forgo the casualty loss and claim a repair deduction.

**Replacement of major component or substantial structural parts.** The cost of replacing a major component or substantial structural part of a unit of property must be capitalized as a restoration (Temp. Reg. §1.263(a)-3T(i)(4)). The determination is based on all the facts and circumstances, including the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property. A major component or substantial structural part includes a part or combination of parts that comprises a large portion of the physical structure of the unit of property, or performs a discrete and critical function in the operation of the unit of property.

**COMMENT:** Although the definition of materials and supplies includes components acquired to maintain, repair, or improve a unit of tangible property the rule which allows a component to be deducted as a material or supply in the year used or consumed does not apply if the component improves a unit of property. Consequently the cost of a major component must be capitalized as an improvement under the rules for restorations and may not be deducted as a material

or supply. Similarly no deduction may be claimed for the cost of an item which is a material or supply if the material or supply replaces a component for which a retirement loss deduction is claimed.

**COMMENT:** This facts-and-circumstances standard replaces the standard in regulations that were proposed in 2008, under which a major component or substantial structural part of a unit of property had to represent at least 50 percent of the replacement cost or the physical structure of the unit of property.

**EXAMPLE:** The cost of replacing the engine and cab on a heavy truck must be capitalized because the engine and cab constitute parts or a combination of parts that comprises a major component or substantial structural part of the truck (Temp. Reg. §1.263(a)-3T(i)(5), Ex. 8).

**EXAMPLE:** CostLo purchases a newly constructed building and eventually replaces the entire roof due to normal wear and tear. The roof comprises a major component or substantial structural part of the building structure and the replacement cost must be capitalized. The result is the same if CostLo replaces only a large portion of the decking, insulation, and membrane of the roof. However, if CostLo simply replaces the waterproof membrane in the roof, the cost does not have to be capitalized. The membrane may affect the function of the building structure, but

it is not by itself a major component or substantial structural part of the building structure (Temp. Reg. 1.263(a)-3T(i)(5), Exs. 12, 13, and 14).

**COMMENT:** The retirement of an entire roof is a disposition of an “asset” because the roof is a structural component and CostLo must recognize a loss unless the building is in a GAA and CostLo chooses not to recognize the loss. Whether or not the loss is recognized, the cost of replacing the entire roof must be capitalized because the entire roof is a substantial structural part of the building structure. Costlo may choose but is not required to treat the components of the roof as separate assets. For example if CostLO treats each 4 × 8 section of decking as an asset, each 10 foot roll of insulation as an asset, and each square foot of the membrane as an asset Costlo must claim a loss deduction for each such component when retired unless the building is in a GAA. If the building is in a GAA CostLo would not want to elect to recognize a loss on the replaced membrane because the cost of replacing the membrane is a deductible repair if a loss is not claimed.

**Deteriorated property restored to a useable condition.** A taxpayer who fails to maintain its property to the point where it is no longer functional must capitalize the costs of returning the property to a functional state (Temp. Reg. §1.263(a)-3T(i)).

## CCH IN-DEPTH COVERAGE

Temporary Regulations by Subject	Regulation Citation	CCH Standard Federal Tax Reporter Discussion	CCH Tax Research Consultant Discussion
Materials and supplies	Temp. Reg. §1.162-3T	¶18610.01 - ¶18610.05	BUSEXP: 18,558
MACRS general asset accounts	Temp. Reg. Reg. §1.168-1T	¶11279.038	DEPR: 3,559
MACRS item and multiple asset accounts	Temp. Reg. Reg. §1.168-7T	¶11279.037	DEPR: 15,210
Dispositions of MACRS property	Temp. Reg. Reg. §1.168-8T	¶11279.037	DEPR: 15,210
Amounts paid to acquire or produce tangible property, including de minimis expensing	Temp. Reg. §1.263(a)-2T	¶13709.012	BUSEXP: 9,080
Amounts paid to improve tangible property	Temp. Reg. §1.263(a)-3T	¶13,709.013 – ¶13,709.01388	BUSEXP: 9,090 - 9,099

**COMMENT:** *The deteriorated property rule is not intended to cover situations where a minor component breaks in the normal course of use and causes a machine to temporarily cease to function. However, the cost of replacing a major component of section 1245 property or a major structural part of a building must always be capitalized as a restoration.*

**EXAMPLE:** *Farmer Jones allowed his barn to fall into such a state of disrepair that it was not structurally sound and no longer functional for its intended use. The cost of shoring up walls and replacing the siding to return the building structure to its ordinarily efficient operating condition must be capitalized as a restoration (Temp. Reg. §1.263(a)-3T(i)(5), Ex. 5).*

**Rebuild to like-new condition.** An expenditure is a capitalized restoration if it results in the rebuilding of the unit of property to a like-new condition after the end of its MACRS class life. The MACRS class life is the same as the MACRS alternative depreciation system (ADS) recovery period for the unit of property. A unit of property is rebuilt to a like-new condition if it is brought to a new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications (Temp. Reg. §1.263(a)-3T(i)(3)).

**IMPACT:** *A rebuild to a like-new condition is not capitalized as a restoration if the rebuild occurs during the class life of the unit of property.*

**EXAMPLE:** *Ten years after ChugaChug places a freight car with a 14 year class life in service, it performs a rebuild that includes a complete disassembly, inspection, and recondition or replacement of components in the suspension and draft systems, trailer hitches, and other special equipment. ChugaChug also modifies the car to upgrade various components to the latest engineering standards. The freight car essentially is stripped to the frame, with all of its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and*

*is reconditioned. The walls of the freight car are replaced or are sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled. At the end of this rebuild, the freight car has been restored to rebuilt condition under the manufacturer's specifications. ChugaChug is not required to capitalize the cost to rebuild a car to like-new condition, because the costs are paid or incurred before the end of the class life of the freight car (Temp. Reg. §1.263(a)-3T(i)(5), Ex. 6).*

**IMPACT:** *Since major components in the freight car are replaced in the above example that is taken directly from the regulations, it can be inferred that the IRS intended a special rule that trumps a more general one: it appears that the cost of replacing those components does not need to be capitalized if the exception to capitalization for rebuilding to a like-new condition during an asset's class life applies.*

### Adaptations Are Capitalized Improvements

An adaptation to a new or different use is a type of improvement that is capitalized (Temp. Reg. §1.263(a)-3T(j)). In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time it was originally placed in service by the taxpayer.

**EXAMPLE:** *ManuCo owns the land that houses its manufacturing facility. ManuCo discontinues manufacturing operations at the site, and decides to sell the property to a developer that intends to use it for residential housing. Amounts paid by ManuCo to regrade the land so that it can be used for residential purposes adapts the land to a new or different use that is inconsistent with ManuCo's use of the property at the time it was placed in service. As a result, the amount paid to regrade the land must be capitalized as an improvement (Temp. Reg. §1.263(a)-3T(j)(3), Ex. 4).*

### Routine Maintenance Safe Harbor

The costs of performing certain routine maintenance activities are currently deductible under a routine maintenance safe harbor. Under the safe harbor, an amount paid is deductible if it is for ongoing activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. The activities are routine only if, at the time the unit of property is placed in service, the taxpayer reasonably expects to perform the activities more than once during the class life of the unit of property (that is, during the recovery period prescribed for the MACRS alternative depreciation system (ADS)) (Temporary Reg. §1.263(a)-3T(g)).

**COMMENT:** *The temporary regs provide that the routine maintenance safe harbor does not apply to buildings or maintenance attributable to wear and tear that occurred on a used property prior to acquisition by the taxpayer. The proposed regulations applied the safe harbor to buildings. Consequently, taxpayers who used the proposal as a justification for deducting a repair expense may need to file an accounting method change to capitalize the costs.*

Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of parts with comparable and commercially available and reasonable replacement parts.

Factors to be considered in determining whether a taxpayer is performing routine maintenance include the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statement.

The safe harbor does not apply to the cost of replacing components if a retirement loss is claimed, gain or loss is realized upon a sale, or a deteriorated and nonfunctional property is restored to its ordinarily efficient operating condition.

**EXAMPLE:** *FormAll purchases a new welder in 2012 for use at its factory. Assume that the machine is the unit of property and has a class life of 10 years. When the machine is placed in service, FormAll expects to perform manufacturer-recommended scheduled maintenance approximately every three years. The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available and reasonable replacement parts. 3 years after placing the welder in service, FormAll pays \$500 to perform the manufacturer recommended scheduled maintenance. The cost is currently deductible under the routine maintenance safe harbor. (Temp. Reg. §1.263(a)-3T(g)(5), Exs. 4 and 5).*

**COMMENT:** *If the welder was purchased used, the costs would not qualify to the extent attributable to the use of the welder by the prior owner. That portion of the scheduled maintenance must be capitalized if it results in a betterment of the welder, including the amelioration of a material condition or defect, or otherwise results in an improvement.*

### Accounting Method Changes

Rev. Proc. 2012-19 adds the following automatic accounting method changes to the Appendix of Rev. Proc. 2011-14 to be used by taxpayers who capitalized amounts that are deductible as repairs under the temporary regulations or who deducted amounts as repairs that are capitalized as improvements under the temporary regulations:

- (1) Change to capitalize amounts paid for improvements to units of property consistent with Temp. Reg. Sec. 1.263(a)-1T and 1.263(a)-3T (Sec. 10.10);
- (2) Change from capitalizing to deducting as repairs under Temp. Reg. §1.162-4T amounts paid for tangible property (Sec. 3.10); and
- (3) Change from capitalizing to deducting amounts that qualify for the routine maintenance safe harbor (Sec. 3.19).

## TAXPAYERS SUBJECT TO FERC, FCC, or STB

A taxpayer subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface Transportation Board (STB) may use its regulatory accounting method to determine whether amounts paid to repair, maintain, or improve tangible property are treated as deductible expenses or capital expenditures (Temporary Reg. §1.263(a)-3T(k)).

The optional regulatory accounting method does not apply to tangible property that is not subject to regulatory accounting rules. The method also does not apply to property for the tax years in which the taxpayer elects to apply the repair allowance under Reg. §1.167(a)-11(d)(2).

The uniform capitalization rules of Code Sec. 263A continue to apply to costs required to be capitalized to property produced by a taxpayer or to property acquired for resale even if the optional method is used.

### Effective Date

The optional regulatory accounting method applies to tax years beginning on or after January 1, 2012 (Temp. Reg. §1.263(a)-3T(p)).

### Accounting Method Change

An automatic change in accounting method procedure may be used to change to the regulatory accounting method (Rev. Proc. 2012-19, adding Section 3.11 to the Appendix of Rev. Proc. 2011-14).

## UNIT OF PROPERTY

The categorization of an expenditure as a capitalized improvement or a deductible repair is greatly affected by the size of the unit of property that is being worked on. The temporary regulations provide specific definitions for a unit of property in the case of buildings and a general rule (the functional interdependence test) for other types

of property (Temp. Reg. 1.263(a)-3T(e)). The rules for determining the unit of property are effective for tax years beginning on or after January 1, 2012 (Temp. Reg. §1.263(a)-3T(p)).

**IMPACT:** *Generally, the larger the unit of property is the more likely that costs will be characterized as a repair rather than a capital expenditure under the new regulations.*

### Buildings

Each building system listed below is treated as a separate unit of property. The building structure (for example, the building shell and all other structural components that are not part of a building system) is treated as a separate unit of property. The building systems treated as separate units of property are (Temp. Reg. 1.263(a)-3T(e)(2)(ii)):

- Heating, ventilation, and air conditioning (“HVAC”) systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators);
- Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures);
- Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from property line to and between buildings and other permanent structures);
- All escalators;
- All elevators;
- Fire-protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire fighting equipment, such as extinguishers, hoses);

- Security systems for the protection of the building and its occupants (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit);
- Gas distribution systems (including associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures); and
- Other structural components identified in future published guidance that are specifically designated as building systems

**IMPACT:** *The proposed regulations treated each building and all of its structural components as a single unit of property. Building systems were not treated as separate units of property. Taxpayers who claimed repair deductions for work on a building system because the entire building was treated as a unit of property will need to file a change of accounting method using automatic procedures provided in Rev. Proc. 2012-19 to redefine their definition of a unit of property and to capitalize the amounts previously deducted as a repair expense.*

### Leased Buildings

If the taxpayer is a lessee of a portion of a building, the portion of the building structure subject to the lease is the unit of property and the portion of any building system associated with that portion of the leased property is a unit of property (Temp. Reg. 1.263(a)-3T(e)(2)(v)). Thus, the lessee's reference point for determining whether its expenditures are repairs or improvements is limited to the portion of the building structure and building systems actually located on the portion of the building that is leased.

**EXAMPLE:** *A lessee of an office space in a large building remodels the bathroom in the office. The expenditure is likely a capital improvement because work was done on a major portion of the plumbing system located within the office space. However,*

*if the lessor performed the same work, it might be considered a repair because the work only affected a small amount of the building's entire plumbing system.*

### Condominiums and Cooperatives

An amount is paid for an improvement to a condominium if the amount paid results in an improvement to the building structure that is part of the condominium or to the portion of any building system that is part of the condominium. In the case of a condominium management association, the association must apply the improvement rules to the entire building structure or to the entire building system (Temp. Reg. 1.263(a)-3T(e)(2)(iii)).

Similarly, for a person with an interest in a cooperative, the unit of property for purposes of determining whether an improvement has been made is the portion of the building structure subject to the taxpayer's possessory rights or to the portion of any building system that is part of the portion of the building structure subject to the taxpayer's possessory rights. In the case of a cooperative housing corporation, the corporation must apply the improvement rules to the entire building structure or to the entire building system (Temp. Reg. 1.263(a)-3T(e)(2)(iv)).

### Personal Property

In the case of property other than a building, all the components that are functionally interdependent comprise a single unit of property. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer (Temp. Reg. §1.263(a)-3T(e)(3)(i)).

**EXAMPLE:** *X owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries and chassis. The locomotive is a single unit of property because it consists entirely of components that are functionally interdependent (Temp. Reg. §1.263(a)-3T(e)(6), Ex. 8).*

### Plant Property

The functional interdependence test could be construed to treat separate pieces of plant equipment that perform functions related to a single industrial process as a single unit of property. To address this issue the unit of property for plant property, as determined under the functional interdependence standard, is further divided into smaller units comprised of each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment (Temp. Reg. §1.263(a)-3T(e)(3)(ii)). Typically, this means that each machine is treated as a separate unit of property.

This rule applies to industrial processes such as manufacturing, power generation, warehousing, distribution, automated materials handling in service industries, or other similar activities.

### Network Assets

For network assets, the unit of property is determined by the taxpayer's particular facts and circumstances, except as otherwise provided in published guidance in the Federal Register or in the Internal Revenue Bulletin. The functional interdependence standard is not determinative (Temp. Reg. §1.263(a)-3T(e)(3)(iii)).

Network assets are defined as railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. They include, for example, trunk and feeder lines, pole lines, and buried conduit. They do not include property that is part of a building structure or building systems or separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels.

**IMPACT:** *The functional interdependence test does not alter or invalidate previously published guidance addressing the treatment of network assets for particular industries, such as Rev. Proc. 2011-43,*

*which provides a safe harbor method for electric utility transmission and distribution property; Rev. Procs. 2011-27 and 2011-28, which provide a network asset maintenance allowance or units of property method for wireline telecommunication network assets and for wireless telecommunication network assets, respectively; and Rev. Procs. 2001-46 and 2002-65, which provide a track maintenance allowance method for Class I railroads and for Class II and III railroads, respectively.*

### Accounting Method Change

An automatic change of accounting method procedure may be used to change the taxpayer's unit of property definition that is used for purposes of determining whether amounts are paid or incurred improve a unit of property (Rev. Proc. 2012-19, adding new section 3.10 to the APPENDIX of Rev. Proc. 2011-14).

## MODIFIED ACCELERATED COST RECOVERY SYSTEM

Previously proposed regulations contained no provisions relating to the Modified Accelerated Cost Recovery System (MACRS)—the depreciation system that applies to tangible assets placed in service after 1986. The temporary regulations, however, add rules relating to MACRS items and mass asset accounts (Temp. Reg. 1.168(i)-7T), the definition of a “disposition” of MACRS property that can trigger the recognition of gain or loss (Temp. Reg. 1.168(i)-8T); and a revision of the existing rules relating to MACRS general asset accounts (GAAs) (Temp. Reg. §1.168(i)-1T).

The connection between the MACRS temporary regulations and the capitalization v. repair issue can be traced to the new MACRS disposition rules which define an “asset” on which gain or loss is recognized when disposed of (Temp. Reg. 1.168(i)-8T(b)(4)). The definition of an asset is directly related to the rule discussed previously which requires a taxpayer to capital-

ize the replacement cost of any component of a unit of property if a loss is claimed on the retired component or if gain or loss is determined by reference to the adjusted basis of the replaced component (Temp. Reg. §1.263(a)-3T(i)).

The disposition rules also expand the definition of a disposition to include the retirement of a structural component of a building (or a component of a structural component defined as an asset by the taxpayer under a reasonable and consistent standard) (Temp. Reg. 1.168(i)-8T(b)(1)). If a loss is claimed on a retired structural component or a component of a structural component treated as an asset the replacement cost cannot be deducted as a repair expense even though it might otherwise qualify as such.

The temporary regulations update the existing MACRS GAA regulations to account for recent law changes such as bonus depreciation (Temp. Reg. §1.168(i)-1T). More significantly, however, they expand the definition of a “qualifying disposition” to include the disposition of any asset in the account (Temp. Reg. §1.168(i)-1T(e)(3)(iii)). Previously, only certain extraordinary dispositions, such as a disposition attributable to a casualty loss, were treated as qualifying dispositions.

**IMPACT:** *If a taxpayer previously retired a structural component of a MACRS building the prior rules did not treat the retirement as a disposition on which loss was recognized. The taxpayer simply continued depreciating the retired structural component (e.g. a replaced roof) and began depreciating the new structural component. The rule treating the retirement of a structural component as a loss disposition is applied retroactively. Accordingly, a taxpayer currently depreciating a retired structural component will need to file a change in accounting method in accordance with procedures contained in Rev. Proc. 2012-20 and claim a negative (taxpayer favorable) Code Sec. 481(a) adjustment equal to the difference between the original basis of the retired structural component and the depreciation that was claimed on the component prior to the tax year of change.*

*Alternatively, a taxpayer may make a retroactive election to place the building in a GAA as provided in Rev. Proc. 2012-20 and either follow the default rule which prohibits a taxpayer from claiming a loss deduction on the disposition of a GAA asset or make a late election to recognize a loss in a qualifying disposition which is also provided in Rev. Proc. 2012-20. If the late election to recognize loss is not made, the taxpayer may simply continue depreciating the retired structural component.*

## DISPOSITIONS OF MACRS PROPERTY

A disposition of MACRS property occurs when ownership of the asset is transferred or when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income. A disposition occurs when an asset is (Temp. Reg. §1.168(i)-8T(b)(1)):

- Sold;
- Exchanged;
- Retired (including retirements of structural component of a building);
- Physically abandoned;
- Destroyed; or
- Transferred to a supplies, scrap, or similar account

The manner of disposition (for example, normal retirement, abnormal retirement, ordinary retirement, or extraordinary retirement) is not taken into account in determining whether a disposition occurs or gain or loss is recognized (Temp. Reg. §1.168(i)-8T(c)).

If a taxpayer elects to treat the cost of a material and supply as a depreciable capital expenditure (Temp. Reg. §1.162-3T(d)) a taxpayer must obtain IRS permission to revoke the election in order to treat the transfer to a supply or scrap account as a disposition.

**IMPACT:** *The temporary regulations expand the definition of a disposition to include retirements of structural components of buildings. This rule corresponds to the treatment that has applied to*

*retirements of a component of a unit of section 1245 property that is treated as an asset. As explained below the regulations also provide a specific definition of an “asset” that may be considered disposed of.*

In addition to treating an entire building, a structural component of a building, or an entire unit of section 1245 property as the asset disposed of, a taxpayer may use a reasonable and consistent method to treat components of structural components and, in most cases, components of a unit of section 1245 property as the “asset” disposed of.

**IMPACT:** *As a result, taxpayers can componentize a larger asset into small assets and claim a retirement loss when the small components are worn and discarded. However, as previously noted, whenever a loss deduction is claimed the cost of replacing a retired component may not be deducted as a repair expense if such cost is otherwise deductible. A taxpayer that has elected general asset account treatment may choose not to claim a retirement loss for an asset that has been disposed of, and would, accordingly, continue to depreciate the basis in the retired property if this choice is made. In addition, and most importantly, a taxpayer may then claim a repair deduction if appropriate.*

## Disposition of Leasehold Improvements

A lessor that makes a leasehold improvement for the lessee and disposes of the improvement before or upon the termination of the lease with the lessee is treated as having made a disposition upon which gain or loss is recognized. A similar rule applies to a lessee of leased property that makes an improvement to the leased property and disposes of the improvement before or upon the termination of the lease (Temp. Reg. §1.168(i)-3T(c)(3)).

**IMPACT:** *Code Sec. 168(i)(8)(B) provides that if a lessor of a building makes an improvement for a lessee and that improvement is irrevocably disposed of or*

*abandoned by the lessor at the termination of the lease the lessor recognizes gain or loss upon the disposition or abandonment of the improvement. The same rule (although not based on a particular Code provision) applies to a lessee who retires a structural component at the termination of a lease by vacating the premises. The regulations appear to be expanding upon Code Sec. 168(i)(8)(B) by treating a lessor’s disposition of a leasehold improvement “before” termination of the lease as a loss event. Moreover, under the temporary regulations, a lessor’s retirement of a leasehold improvement after expiration of the lease should be a loss event. Once the lease has expired the lessor should be subject to the rule that is generally applicable to all other taxpayers under the temporary regulations, viz., the retirement of a*

*structural component is a disposition that generates a loss equal to the adjusted depreciable basis of the retired component.*

## Determining Asset Disposed of

A key new provision in the MACRS disposition regulations provides a definition of an “asset” for disposition purposes (Temp. Reg. Sec.1.168(i)-8T(c)(4)).

Generally, the asset may not be larger than a unit of property and in determining what the “asset” is, all of the facts and circumstances of the disposition should be considered.

**Buildings.** Each building other than its structural components is an asset and each structural component is an asset.

## EFFECTIVE DATES AND DEADLINES

The temporary “repair” regulations, including the portions dealing with MACRS, are generally effective for tax years beginning on or after January 1, 2012. However, the following provisions are effective for amounts *paid or incurred* (to acquire or produce property) in tax years beginning on or after January 1, 2012.

- Temp. Reg. §1.162-3T, relating to materials and supplies. However, a taxpayer may apply Temp. Reg. §1.162-3T(e) (the optional method of accounting for rotatable and temporary spare parts) to taxable years beginning on or after January 1, 2012.
- Temp. Reg. § 1.263(a)-3T(f)(2)(iii) allowing a deduction for amounts paid or incurred to investigate the acquisition of real property.
- Temp. Reg. §1.263(a)-3T(f)(2)(iv) which treats amounts paid for employee and overhead as amounts that do not facilitate the acquisition of real or personal property.
- Temp. Reg. §1.263(a)-3T(f)(3)(ii) which treats inherently facilitative amounts allocable to real or personal property as capital expenditures even if the property is not eventually acquired or produced.
- Temp. Reg. §1.263(a)-3T(g) relating to the de minimis expensing rule

A change in accounting method to adopt any provision that is effective for amounts paid or incurred in tax years beginning on or after January 1, 2012 is generally applied on a cut-off basis. That is, a taxpayer continues to use the old accounting method for items paid or incurred in tax years beginning before January 1, 2012 and applies the new method for items paid or incurred in tax years beginning on or after January 1, 2012. Accordingly, no Code Sec. 481(a) adjustment should be required if a cut-off method change is adopted for the first tax year beginning on or after January 1, 2012.

The temporary regulations expire on December 23, 2014 but the IRS is expected to issue final regulations as soon as possible, perhaps as soon as the end of 2012.

Condominium units and cooperatives (other than their structural components) are treated as separate assets and each structural component is treated as an asset.

**EXAMPLE:** *A taxpayer owns an office building with four elevators. The taxpayer replaces an elevator, which is a structural component. The retirement of the elevator is a disposition and depreciation on the elevator ceases at the time of its retirement. The retirement for depreciation purposes is deemed to occur at the mid-point of the month of retirement under the mid-month convention that applies to the building (including its structural components). The taxpayer must recognize a loss upon the retirement equal to the adjusted depreciable basis of the elevator unless the building is in an MACRS general asset account. If the taxpayer cannot determine from its records the basis of the retired elevator it may use any reasonable method to do so (Temp. Reg. §1.168(i)-8T(h), Ex. 5).*

**COMMENT:** *If a taxpayer disposes of an entire building, the entire building including its structural components should be treated as the asset disposed of. A taxpayer should not compute gain or loss separately on each structural component (except for components that are separately depreciable replacements).*

A taxpayer may use any reasonable, consistent method to treat each of a building's structural components as the asset disposed of (Temp. Reg. §1.168(i)-8T(c)(4)(ii)(E)[F]).

**IMPACT:** *In the case of a building, a highly granular definition of an asset should only be chosen if the building is placed in a GAA. If the GAA election is not made then a taxpayer must recognize a loss on each retirement and no repair deduction may be claimed. If the asset is in a GAA the taxpayer can follow the default no loss rule for assets in a GAA in situations where the expenditure would result in a repair deduction if no loss was claimed and it can elect to claim the loss under the GAA rules for qualifying dispositions if the expenditure must*

*be capitalized whether or not the loss is claimed.*

**EXAMPLE:** *A taxpayer treats each shingle on a roof (the structural component) as an asset disposed of. The building is in a GAA. The taxpayer replaces a portion of the worn shingles with similar shingles. If the building is not in a GAA the taxpayer must recognize a loss on the retired shingles and may not claim a repair loss. If the building is in a GAA no loss is recognized on the retired shingles (the default rule since no election is made to recognize the loss) and a repair deduction may be claimed.*

**EXAMPLE:** *Assume the same facts except that the worn shingles are replaced with a new type of substantially improved shingle and the cost must be capitalized. If the building is in a GAA, the taxpayer will want to elect to claim a loss on the retired shingles under the rules for qualifying dispositions since no repair deduction may be claimed even if a loss on the retirement is not claimed.*

**Property other than buildings.** In the case of personal property or real property other than buildings (for example, a land improvement) the asset is the same as the unit of property unless a taxpayer applies the reasonable and consistent standard to treat components of the unit of property as the "asset" disposed of (Temp. Reg. §1.168(i)-8T(c)(4)).

The rule which allows a taxpayer to use a reasonable and consistent method to treat components of a larger asset as a unit of property, however, does not apply to property described in Asset Classes 00.11 through 00.4 of Rev. Proc. 87-56 or to property (other than any building) described in Code Sec. 168(e)(3).

**IMPACT:** *A loss deduction cannot be claimed on the retirement of a component of a property described in Asset Classes 00.11 through 00.4 of Rev. Proc. 87-56 or in Code Sec. 168(e)(3) because components of such property cannot be treated as separate assets. Taxpayers have complained that it is unfair to exclude these assets from the reasonable and consistent*

*standard and the IRS has not offered any specific reason why they were excluded. Presumably the IRS wanted to simplify the treatment of these particular assets since they are in such widespread use.*

Rev. Proc. 87-56 provides MACRS recovery periods for most assets. Asset Classes 00.11 through 00.4 describes the following common-use business assets: office furniture, fixtures, and equipment; information systems (including computers and peripheral equipment); data handling equipment; noncommercial airplanes; helicopters; automobiles and taxis; buses; light and heavy trucks; tractor units; trailers; trailer-mounted containers; vessels, barges, and tugs not used in marine construction; industrial steam and electric generation/distribution systems, and land improvements not described in a specific business activity class.

Code Sec. 168(e)(3) includes rent-to-own property, semi-conductor manufacturing equipment, computer-based telephone central office switching equipment, qualified technological equipment, section 1245 property used in connection with research and experimentation, certain types of energy producing property (e.g., solar and wind), railroad track, certain natural gas gathering and distribution lines, qualified smart electric meters and grid systems, municipal wastewater treatment plants, telephone distribution plants and comparable equipment used for 2-way exchange of voice and data communications, and section 1245 property used in the transmission at 69 or more kilovolts of electricity for sale.

### **Determining Basis of Asset Disposed of**

The basis of an asset for purposes of determining gain or loss is its adjusted depreciable basis (generally cost less previously claimed depreciation) at the time of the disposition taking into account the applicable MACRS convention (Temp. Reg. §1.168(i)-8T(e)(1)).

If a structural component of a building is retired or a component of a structural component that is treated as an asset is retired it may



be impractical to determine the component's adjusted depreciable basis for purposes of determining gain or loss. In this situation, the IRS will allow a taxpayer to use any reasonable method that is consistently applied to the building to compute the adjusted depreciable basis. The same rule applies to determine the basis of components of a unit section 1245 property ((Temp. Reg. §1.168(i)-8T(e)(2)).

**COMMENT:** *The IRS does not provide any examples of reasonable methods. One intriguing possibility suggested by some commentators and favorably considered by an IRS official involved in drafting the regulations in an informal discussion is to derive the original cost of a building component by applying an inflation adjustment factor to the cost of the new component.*

**IMPACT:** *In the past, cost segregation studies did not usually provide information on the valuation of structural components of buildings (section 1250 property) because structural components are not separately depreciable over shortened recovery periods. This will likely change now that retirements of structural components and components of structural components can generate a loss deduction.*

### Change in Accounting Method

The following automatic change in accounting methods relating to buildings and structural components are added to the Appendix of Rev. Proc. 2011-14 by Rev. Proc. 2012-20:

- (1) A change to identify the appropriate asset disposed of (Sec. 6.29);
- (2) A change from capitalizing an asset previously disposed of (e.g. structural component) to recognizing gain or loss (Sec. 6.29); and
- (3) A change from an improper method of identifying assets disposed of from multiple asset account (e.g., LIFO) to a proper method (Sec. 6.29).

The following additions to the Appendix of Rev. Proc. 2011-14 relate to section

1245 property, land improvements, and components:

- (1) A change to identify the appropriate asset disposed of (Sec. 6.30);
- (2) A change from capitalizing an asset previously disposed of to recognizing gain or loss (Sec. 6.30(3)); and
- (3) A change from an improper method of identifying assets disposed of from multiple asset account (e.g., LIFO) to a proper method (Sec. 6.30(3)).

## MACRS GENERAL ASSET ACCOUNTS

The temporary repair regulations revise the existing MACRS regulations dealing with general asset accounts (Temp. Reg. §1.168(i)-1T)). The most important changes to the GAA rules treat the retirement of a structural component as a disposition and define an asset for purposes of a disposition. (These changes are identical to the rules discussed above that define a disposition and an "asset" for purposes of item and multiple asset (pool) accounts). In addition, the temporary regulations expand the definition of a qualifying disposition for which a taxpayer may elect to recognize gain or loss to include ordinary dispositions in addition to extraordinary dispositions from a GAA. Other minor "tweaks" update the GAA rules to reflect "recent" developments such as the bonus depreciation deduction.

As discussed in more detail below, Rev. Proc. 2012-20 allows taxpayers to retroactively elect to place existing assets into a GAA for a taxpayer's first and second tax years ending after December 31, 2011. This presents a significant opportunity for many businesses but the specific deadlines must be met.

**COMMENT:** *This portion of the briefing will only provide a broad overview of the GAA temporary regulations with particular attention to the most important changes to the existing rules and how they interact with the temporary regulations dealing with the repair v. capitalization issue (viz. Temp. Reg. §1.263(a)-3T).*

## Rules for Grouping Assets into a GAA

Assets that may be grouped into a single general asset account may be divided and placed into more than one general asset account (Temp. Reg. §1.168(i)-1T(c)(1)). For example, a taxpayer may create a separate general asset account for each item of property that could otherwise be grouped into a single GAA (i.e., create GAAs with only one asset).

In order to ensure that only assets that are depreciated the same way are placed in the same GAA, a GAA may only include assets that (Temp. Reg. §1.168(i)-1T(c)(2)):

- (1) Have the same MACRS depreciation method;
- (2) Have the same MACRS recovery (depreciation) period;
- (3) Have the same MACRS convention; and
- (4) Are placed in service in the same tax year.

**EXAMPLE:** *Rainbow Inc. purchases 100 machines in the same tax year. The machines are 5-year MACRS property depreciated using the 200 percent declining balance method and half-year convention. Rainbow may create a single GAA for all of the machines or as many as 100 GAAs if Rainbow decides to place each machine in its own GAA.*

**COMMENT:** *The old GAA rules only allowed assets from the same Rev. Proc. 87-56 Asset Class to be placed in the same GAA. For example, a car (5-year MACRS property described in Asset Class 00.22) could not be placed in a GAA with a heavy general purpose truck (Asset Class 00.242) even though depreciation is computed identically on both items (Reg. §1.168(i)-1(c)(2), prior to amendment by T.D. 9564). The temporary regulations do away with this limitation.*

Assets that are subject to the mid-quarter convention may only be placed in the same GAA account if they are placed in service in the same quarter of the tax year. This is because MACRS depreciation percentages

(rates) are based on the quarter of the tax year in which an asset is placed in service if it is subject to the mid-quarter convention.

Similarly, assets subject to the mid-month convention may be placed in the same GAA account only if placed in service in the same month of the tax year since the depreciation rate is based on the month of the tax year in which such property is placed in service. Note that 39-year nonresidential real property and 27.5-year residential rental property are the only assets that are subject to the mid-month convention. However, 39-year nonresidential real property and 27.5-year residential rental property may not be placed in the same GAA because they have different recovery periods (i.e., 39 years and 27.5 years, respectively).

**CAUTION:** *As explained, below, it is not advisable to place more than one building in the same GAA.*

Property subject to special depreciation computation rules cannot be mixed with other property in the same GAA. The following restrictions are among the most significant: (Temp. Reg. §1.168(i)-1T(c)(2)(ii)(C)-(I)):

- (1) Passenger automobiles subject to the luxury car depreciation limits of Code Sec. 280F must be grouped in a separate GAA;
- (2) Assets for which bonus depreciation was claimed may only be grouped into a GAA with assets for which a similar bonus depreciation rate applied;
- (3) Except for passenger automobiles subject to the luxury car depreciation limits which must be placed together in a separate account, listed property (as defined in Code Sec. 280F(d)(4)) must be grouped into a separate GAA;
- (4) Assets for which the depreciation allowance for the placed-in-service year is not determined by using an optional depreciation table must be grouped into a separate GAA; and
- (5) Mass assets (described below) the disposition of which will be identified by a mortality dispersion table must be grouped in a separate GAA.

### GAA Computational Rules

Depreciation (including bonus depreciation) on a GAA is computed on the combined bases of the assets in the GAA (after reduction by any amounts expensed under Code Sec. 179) as if the GAA is a single asset. Depreciation allowances determined for each GAA must be recorded in a depreciation reserve account for each account (Temp. Reg. §1.168(i)-1T(d)(1)).

**EXAMPLE:** *ABC Inc. places two machines costing \$100,000 each in the same general asset account in 2012. The machines are MACRS 3-year property depreciated using the 200 percent declining balance method and half-year*

**“It is not advisable to place more than one building in the same GAA.”**

*convention. Assume that ABC claims a \$50,000 section 179 deduction for one of the machines and bonus depreciation at a 50% rate (for both machines). The unadjusted depreciable basis of the account is \$150,000 (\$200,000 – \$50,000). The bonus deduction is equal to \$75,000 (\$150,000 unadjusted depreciable basis × 50% bonus rate). The remaining adjusted depreciable basis is \$75,000 (\$150,000 unadjusted depreciable basis – \$75,000 bonus). 2012 depreciation deduction for the GAA is \$24,997.50 (\$75,000 remaining adjusted depreciable basis × 33.33% first year table percentage); 2013 = \$33,337.5 (\$75,000 × 44.45%); 2014 = \$11,107.50 (\$75,000 × 14.81%); 2015 = \$5,557.50 (\$75,000 × 7.41%).*

### Disposition of Asset from GAA

Upon the disposition of an asset from a GAA, the following rules apply *if a taxpayer does not elect to recognize gain or loss under*

*the rules for a qualifying disposition (Temp. Reg. §1.168(i)-1T(e)):*

- Immediately before the disposition the asset is treated as having an adjusted depreciable basis of zero;
- No loss is realized;
- Any amount realized is recognized as ordinary income to the extent that the sum of the unadjusted depreciable basis of the GAA and any expensed cost of assets in the account exceeds amount previously recognized as ordinary income; and
- The unadjusted depreciable basis and depreciation reserve of the GAA are not affected by the disposition and, accordingly, a taxpayer continues to depreciate the GAA, including the asset disposed of, as if no disposition occurred.

Unless an election is made to recognize gain or loss by reference to the adjustment basis of a disposed-of asset (either in a “qualifying disposition” or upon the disposition of all assets or the last asset in the GAA), any amount realized on a disposition of an asset from a GAA is recognized as ordinary income. Ordinary income is recognized to the extent the sum of the unadjusted depreciable basis of the general asset account and any expensed cost (e.g., Code Sec. 179) for assets in the account exceeds any amounts previously recognized as ordinary income upon the prior disposition of other assets in the account. The recognition and character of any excess amount realized are determined under applicable provisions of the Internal Revenue Code (other than the ordinary income depreciation recapture provisions of Code Sec. 1245 and Code Sec. 1250) (Code Sec. 168(i)(4); Temp. Reg. §1.168(i)-1T(e)(2)(ii)). Thus, the excess will generally be treated as section 1231 gain.

**IMPACT:** *This gain recognition rule has the potential of converting an amount that would otherwise qualify as section 1231 gain into ordinary income. Thus, if an amount is realized from the disposition of an asset in a multi-asset GAA account a taxpayer should consider an election to compute gain or loss by reference to*

*the actual adjusted basis of the disposed-of asset under the rules for qualifying dispositions or under the rules for dispositions of all of or the last asset in a GAA.*

**IMPACT:** *Previously, the disposition of an asset from a multi-asset GAA account was not usually treated as a qualifying disposition and a taxpayer was required to recognize ordinary income to the extent of any amount realized. This limiting factor has been removed by the temporary regulations as a result of the expansion of the definition of a qualifying disposition to include virtually all asset dispositions.*

**Determining asset disposed of.** The rules for determining the asset disposed of from a GAA are essentially identical to the rules described above for item accounts. Thus, the facts and circumstances of each disposition are considered in determining what is the appropriate asset disposed of (Temp. Reg. §1.168(i)-1T(e)(2)(viii)). The asset generally cannot be larger than a unit of property. Each structural component of a building is a separate asset and each unit of section 1245 property is a separate asset, except that taxpayers may use a reasonable and consistent method to treat components of structural components as separate assets and components of section 1245 property as separate assets. However, components of property described in Asset Classes 00.11 through 00.4 of Rev. Proc. 87-56 and in Code Sec. 168(e)(3) cannot be treated as separate assets.

The pre-January 1, 2012 GAA regulations contained no rules regarding the definition of an asset disposed of from a GAA (Reg. §1.168(i)-1, prior to amendment by T.D. 9564).

**Disposition defined.** An asset in a GAA is considered disposed of when ownership of the asset is transferred or when the asset is permanently withdrawn from use in either a trade or business or the production of income (Temp. Reg. §1.168(i)-1T(e)(1)).

Dispositions include:

- The sale, exchange, retirement, physical abandonment, or destruction of an asset;

- The transfer of an asset to a supplies, scrap, or similar account;
- The retirement of a structural component of a building.

**COMMENT:** *Under the prior GAA rules, the retirement of a structural component was not a disposition (Reg. §1.168(i)-1(e)(1), prior to amendment by T.D. 9564).*

**EXAMPLE:** *DEF maintains one general asset account for one office building that cost \$10 million. DEF replaces the entire roof. The retirement of the roof, which is a structural component of the building, is a disposition. This roof is treated as having an adjusted depreciable basis of zero and DEF may not recognize any loss upon the retirement of the roof (unless DEF elects to recognize the loss under the rules for a qualifying disposition). The unadjusted depreciable basis of the general asset account for the office building is not affected by the retirement and, as a result, DEF continues to depreciate the \$10 million cost of the GAA. The new roof is depreciated separately and is not an asset in the building's GAA but may be placed in its own GAA (Temp. Reg. §1.168(i)-1T(e)(2)(ix), Ex. 1).*

**Election to recognize gain or loss in a qualifying disposition.** In the case of a “qualifying disposition” of an asset that is not the last asset in a GAA, a taxpayer may elect on a timely filed (including extensions) original return for the year of disposition to terminate GAA treatment for the asset as of the first day of the tax year of disposition and determine the amount of gain, loss, or other deduction for the asset by taking into account the asset's adjusted depreciable basis at the time of the disposition (Temp. Reg. §1.168(i)-1T(e)(3)(iii)(A)).

**COMMENT:** *If the election is not made no loss is recognized and the entire amount realized (if any) is generally ordinary income.*

The adjusted depreciable basis of the asset at the time of the disposition (as determined under the applicable convention

for the GAA in which the asset was included) equals the unadjusted depreciable basis of the asset (generally, cost less section 179) less the depreciation allowed or allowable for the asset, computed by using the depreciation method, recovery period, and convention applicable to the GAA in which the asset was included and by including the portion of any bonus depreciation claimed for the GAA that is attributable to the asset.

The recognition and character of the gain, loss, or other deduction are determined under applicable provisions of the Internal Revenue Code as if the asset was not in a GAA. However, the amount of gain subject to ordinary income depreciation recapture under Code Sec. 1245 or Code Sec. 1250 is limited to the lesser of:

- (1) The depreciation allowed or allowable for the asset, including any expensed cost (or the bonus depreciation allowed or allowable for the asset); or
- (2) The excess of—
  - (a) The original unadjusted depreciable basis of the GAA plus, in the case of section 1245 property originally included in the GAA, any expensed cost; over
  - (b) The cumulative amounts of gain previously recognized as ordinary income upon the prior disposition of particular assets or under Code Sec. 1245 or Code Sec. 1250.

A qualifying disposition is a disposition that does not involve all the assets, or the last asset, remaining in a GAA. However, the following dispositions are not qualifying dispositions (Temp. Reg. §1.168(i)-1T(e)(3)(iii)(B)):

- Transactions subject to Code Sec. 168(i)(7);
- Transactions subject to Code Sec. 1031 or Code Sec. 1033;
- Technical terminations of partnerships; and
- Dispositions that are subject to GAA anti-abuse rules.

**COMMENT:** *Under the prior GAA rules, a qualifying disposition only included*

*extraordinary dispositions such as dispositions resulting from a casualty loss, a charitable contribution, the termination of a business, and certain nonrecognition transactions. Without making nearly every disposition a qualifying disposition it would make no sense to place a building in a GAA because no loss on a structural component could ever be recognized. Similarly, no loss could be recognized on the retired components of an item of section 1245 property in a GAA. The expansion of the definition of a qualifying disposition now gives a taxpayer the flexibility to decide whether or not to recognize a loss whenever a component of an asset in a GAA is retired.*

**IMPACT:** *The new-found importance of the GAA election is highlighted by the fact that the American Institute of CPAs (AICPA) has recommended that the IRS amend the GAA regulations to make the GAA election the default rule for buildings, i.e., require taxpayers to elect out of GAA treatment rather than make an affirmative election into it. It would prefer, however, that the IRS simply make the recognition of loss upon the retirement of a structural component outside of a GAA elective. It is unclear why the IRS chose to require taxpayers to place a building in a GAA in order to avoid a strict application of the loss recognition rule for each disposition of a structural component when the same result could have been achieved more simply and effectively by making the loss recognition rule on the retirement of a structural component elective.*

If the taxpayer elects to terminate GAA treatment for an asset disposed of in a qualifying disposition (Temp. Reg. §1.168(i)-1T(e)(3)(iii)(C)):

- (1) The asset is removed from the GAA as of the first day of the tax year in which the qualifying disposition occurs and is placed in a single asset account;
- (2) The unadjusted depreciable basis of the GAA is reduced by the unadjusted depreciable basis of the asset as of the first day of the tax year of disposition;
- (3) The depreciation reserve of the GAA is reduced by the depreciation allowed

or allowable for the asset as of the end of the tax year immediately preceding the tax year of disposition, computed by using the depreciation method, recovery period, and convention applicable to the GAA and by including the portion of the bonus depreciation deduction claimed for the GAA that is attributable to the asset; and

“The American Institute of CPAs (AICPA) has recommended that the IRS amend the GAA regulations to make the GAA election the default rule for buildings.”

- (4) Any portion of the cost of the asset that was expensed under Code Sec. 179 is disregarded for purposes of determining the amount of gain realized on subsequent dispositions that is subject to ordinary income treatment under the rules generally applicable to the disposition of an asset in a GAA.

**EXAMPLE:** *GED Inc. placed a building into a single asset GAA in 2012. The building cost \$500,000. In 2014, the entire roof is replaced. GED must capitalize the cost of the new roof and, therefore, decides to elect to recognize a loss on the replaced roof. GED determines that the unadjusted depreciable basis of the retired roof (original cost) is \$50,000 and that its adjusted depreciable basis at the time of replacement (cost less depreciation claimed on the roof prior to retirement) is \$47,000. \$47,000 is claimed as an ordinary loss deduction. The retired roof is treated as removed from the GAA and the unadjusted depreciable basis of the GAA (\$500,000) is reduced by the unadjusted depreciable basis of the roof (\$50,000) to \$450,000. The new roof is separately depreciated and GED may elect to place it in another GAA or in an item account.*

**Election to recognize gain or loss upon disposition of last asset in GAA.** Upon the disposition of all of the assets, or the last asset, in a GAA, a taxpayer may elect to recognize gain or loss by reference to the adjusted depreciable basis of the GAA. If this optional method is elected (Temp. Reg. §1.168(i)-1T(e)(3)(ii)):

- The GAA terminates;
- The amount of gain or loss for the GAA is determined by taking into account the adjusted depreciable basis of the GAA at the time of the disposition (determined by using the applicable depreciation convention for the GAA); and
- The recognition and character of the gain or loss are determined under other applicable provisions of the Internal Revenue Code, except that the amount of gain subject to ordinary income depreciation recapture under Code Sec. 1245 and Code Sec. 1250 is limited to the excess of the depreciation allowed or allowable for the GAA, including any expensed cost, over any amounts previously recognized as ordinary income upon the prior disposition of particular assets.

**EXAMPLE:** *Assume that GED above sells the building including the new roof placed in service in 2014, in 2016 for \$660,000. GED reasonably allocates \$60,000 of this amount to the cost of the new roof. Assume that the total depreciation claimed on the building (excluding depreciation claimed on the retired roof and depreciation claimed on the new roof) is \$6,660 (i.e., the account's depreciation reserve). If GED elects the optional method, gain recognized on the building is \$143,340 (\$660,000 – \$60,000 – \$450,000 – \$6,660). The entire gain is section 1231 gain. No amount is recaptured as ordinary income because an MACRS building is not subject to depreciation recapture under Code Sec. 1250.*

**COMMENT:** *Since the new roof is a separately depreciated asset that is not in the building's GAA, gain or loss on the new roof will be computed separately if GED elects the optional method on the disposition of the new roof.*

**EXAMPLE:** *RST, a calendar-year corporation, maintains a GAA for one item of equipment that cost \$2,000 and is placed in service in 2012. No Code Sec. 179 or bonus deduction is claimed. The equipment is 5-year property subject to the half-year convention. In June 2014, RST sells the equipment for \$1,000 and elects the optional method. As a result, the GAA terminates and gain or loss is determined for the GAA. On the date of disposition, the adjusted depreciable basis of the account is \$768 (unadjusted depreciable basis of \$2,000 less the depreciation allowed or allowable of \$1,232 (\$400 + \$640 + 192). Thus, in 2014, RST recognizes gain of \$232 (amount realized of \$1,000 less the adjusted depreciable basis of \$768). The gain of \$232 is subject to Code Sec. 1245 recapture to the extent of the depreciation allowed or allowable for the account (plus the expensed cost for assets in the account) less the amounts previously recognized as ordinary income (\$1,232 + \$0 expensed - \$0 previously recognized = \$1,232). As a result, the entire gain of \$232 is recaptured as ordinary income under Code Sec. 1245 (Temp. Reg. §1.168(i)-1T(e)(3)(ii)(B), Ex. 2).*

**CAUTION:** *If a building is in a GAA and the building is disposed of, it is particularly important to make an election to recognize gain or loss by reference to the adjusted basis of the building because (as previously explained) the amount realized will be treated as ordinary income to the extent of the building's unadjusted depreciable basis (i.e., original cost) less any amount previously recognized as ordinary income if the election is not made. The election to recognize gain in a qualifying disposition or for the disposition of the last asset in the GAA account is made by reporting the gain or loss, or other deduction, on the taxpayer's timely filed (including extensions) original return for the tax year in which the disposition occurs. Thus, if a taxpayer fails to file a timely return for the year of sale, the default rule will apply since the election will not have been made within the required time limit.*

**COMMENT:** *Due to the possibility of inadvertently transforming section 1231*

*gain into ordinary income upon a disposition, it is strongly advised not to place two or more buildings in the same GAA. As previously explained, however, buildings cannot be placed in the same GAA unless they are acquired in the same month of the same tax year. This consideration is not as important in the case of section 1245 property insofar as gain from section 1245 property is usually characterized as ordinary depreciation recapture income.*

### Identifying Asset Disposed of from Multi-Item GAA

The following methods may be used for purposes of identifying the asset disposed of from a multi-asset GAA: the specific identification method, the FIFO method, the modified FIFO method, a mortality dispersion table if the asset disposed of is a mass asset grouped in a GAA with other mass assets, or any method designated by the Secretary. The LIFO method is not permitted (Temp. Reg. §1.168(i)-1T(j)). The former regulations did not provide these rules.

### GAA Election Procedure

A taxpayer may make an irrevocable election to include assets in an MACRS general asset account (GAA) (Code Sec. 168(i)(4)). The election is made separately by each person owning an asset to be placed in a GAA. For example, the election is made by each member of a consolidated group, each partnership, or each S corporation (Temp. Reg. §1.168(i)-1T(l)(1)). Partners and S shareholders do not make the election for property owned by the pass-through entity. The election is made by following the Form 4562 instructions. The instructions simply require a taxpayer to check a box on Form 4562 (line 18 of the 2011 form) to indicate that the election is being made. The election must be made by the due date (including extensions) of the return for the tax year in which the assets included in the GAA are placed into service.

### Retroactive GAA Elections

A taxpayer may make a retroactive GAA election, a late election to treat a disposi-

tion as a qualifying disposition, and a late election to recognize gain or loss on the disposition of the remaining assets or last asset in a GAA during its first or second tax year beginning after December 31, 2011 (Rev. Proc. 2012-20, adding Sec. 6.32 to the Appendix of Rev. Proc. 2011-14).

**IMPACT:** *If no retroactive GAA election is made, a taxpayer will account for the loss deduction on a previously retired structural component of a building that is still being depreciated by filing a change in accounting method and reporting a Code Sec. 481(a) adjustment. Beginning in the year of change, no depreciation may be claimed on the basis attributable to the replaced structural component and a loss deduction must be claimed on any structural components retired in the future. Alternatively, a taxpayer may make a retroactive GAA election for the building and then choose to adhere to the GAA default rule (no loss recognition and continued depreciation on the retired component) or make a late election to recognize the loss in a qualifying disposition (also permitted for two years) and claim a Code Sec. 481(a) adjustment.*

A third alternative applies to buildings placed in service in tax years ending before December 30, 2003. Under this alternative a taxpayer files amended returns for open years to remove the depreciation claimed in those open years on the previously retired structural components. However, no adjustment, including a Code Sec. 481(a) adjustment, to account for the loss is permitted even though the basis of the building must be reduced by the adjusted depreciable bases of the retired components. Future retirements will result in a loss deduction. This approach is not considered a change in accounting method. It is not recommended because the basis reduction is not offset by depreciation deductions.

### Effective Date

The GAA regulations apply to tax years beginning on or after January 1, 2012 (Temp. Reg. §1.168(i)-1T(m)(2)).

## Change in Accounting Methods

The following automatic change in accounting methods relating to GAAs are added to the Appendix of Rev. Proc. 2011-14 by Rev. Proc. 2012-20:

- (1) Moving assets within one GAA account to another GAA account (Sec. 6.28);
- (2) A change to identify the appropriate asset disposed of (Sec. 6.31);
- (3) Change in proper method of identifying assets disposed of from a multiple-asset GAA account to another proper method (Sec. 6.28);
- (5) A change from improper method of identifying assets disposed of from GAA (e.g., LIFO) to a proper method (Sec. 6.31);
- (6) Late GAA election for assets placed in service in tax years beginning before 2012 (Sec. 6.32);
- (7) Late election to recognize gain or loss on disposition of all assets or last asset in GAA (Sec. 6.32); and
- (8) Late election to recognize gain or loss in a qualifying GAA disposition (Sec. 6.32).

**COMMENT:** *Although a regulatory "election" is not normally treated as a change in accounting method (Reg. §1.446-1(e)(2)(ii) (d)(3)), the IRS treats the late election to establish a GAA for existing property, the late election to recognize gain or loss on the disposition of all of the assets or the last asset from a GAA, and the late election to recognize a gain or loss on a qualifying disposition of an asset from a GAA provided in Rev. Proc. 2012-20 as a change in accounting method (Rev. Proc. 2012-20, adding Sec. 6.32 to the Appendix of Rev. Proc. 2011-14).*

## MACRS SINGLE ASSET AND MULTIPLE ASSET ACCOUNTS

Taxpayers have been accounting for MACRS property in single asset (item) accounts and multiple asset (pool) accounts without the benefit of regulatory guidance. Temporary Reg. § 1.168(i)-7T now provides specific rules that must be

followed effective for tax years beginning on or after January 1, 2012.

**IMPACT:** *The temporary regulations for item and pool accounts have no significant connection to the repair v. capitalization issue. However, taxpayers may need to change their accounting method to bring their current pool account treatment for MACRS assets into compliance with the temporary regulations. However, in most cases, taxpayers who are currently using multiple asset accounts are likely to be in compliance with the intuitive principles of the regulation.*

A taxpayer may account for MACRS property by (Temp. Reg. §1.168(i)-7T(a)):

- (1) Treating each individual MACRS asset as an account (a "single asset account" or an "item account");
- (2) By combining two or more MACRS assets in a single account (a "multiple asset account" or a "pool"); or
- (3) By establishing a general asset account (as described previously)

For example, if a taxpayer purchases two business cars during the current tax year, the taxpayer may separately depreciate each car. If this choice is made, each car is treated as a single asset account or item account. Assuming that certain requirements described below are satisfied and the cars are placed in the same account (i.e., in a multiple asset account or pool), depreciation is computed on the combined cost of the vehicles.

**COMMENT:** *A general asset account may contain multiple items of similar property or a single item of property. The difference between a GAA and an item or multiple asset account relates primarily to the way in which gain or loss is accounted for when an asset in the account is disposed of. In a GAA the full amount realized upon a disposition of a GAA asset is recognized as ordinary income and no loss deduction is allowed, unless an election is made to recognize gain or loss by reference to the asset's adjusted basis. In an item or pool account, gain or loss is separately recognized on each disposed of asset by reference to its adjusted basis.*

An asset must be accounted for in a single asset account if (Temp. Reg. §1.168(i)-7T(b)):

- (1) The asset is used partially in a trade or business and partially in a personal activity;
- (2) The asset is placed in service and disposed of in the same tax year;
- (3) The asset is in a general asset account and general asset account treatment for the asset terminates under the GAA rules, for example, because the asset is used for personal purposes in a tax year after it is placed in service;
- (4) The taxpayer disposes of a component of a larger asset and the unadjusted depreciable basis of the disposed of component is included in the unadjusted depreciable basis of the larger asset

**Rules for combining assets into a multiple asset account or pool.** Assets may be placed in the same multiple asset account or pool only if:

- (1) The assets are placed in service in the same tax year;
- (2) The assets have same depreciation method;
- (3) The assets have the same recovery period; and
- (4) The assets have the same depreciation convention (Temp. Reg. §1.168(i)-7T(c)(2)(i)).

For example, a pool may be established for MACRS 5-year property (i.e. MACRS property with a 5-year recovery period) even if the property is not of the same type, so long as the property is placed in service in the same tax year and is subject to the same depreciation method (e.g. 200 percent declining balance method, 150 percent declining balance method, or straight-line method) and convention (e.g., half-year or mid-quarter convention). If the mid-quarter convention applies, the property must have been placed in service in the same quarter of the same tax year and if the mid-month convention applies in the same month of the same tax year .

**COMMENT:** *The rules for combining assets in a multiple asset account or pool ensure that only assets that are depreciated in exactly the same way can be placed in the*

*same account. Identical rules for combining assets in a multiple asset account also apply to combining assets into a general asset account.*

In addition to the requirement that only assets with the same depreciation method, recovery period, and convention may be placed in the same multiple asset account or pool the following special grouping rules apply to the following property as a result of factors that affect the computation of depreciation (Temp. Reg. §1.168(i)-7T(c)(2)(ii)):

- (1) Passenger automobiles subject to the luxury car depreciation caps (Code Sec. 280F) must be grouped into a separate multiple asset account or pool;
- (2) Assets for which bonus depreciation is claimed cannot be grouped with assets for which bonus depreciation is not claimed;
- (3) Assets for which bonus depreciation is claimed may only combined if the same bonus rate applies;
- (4) Listed property (as defined in Code Sec. 280F(d)(4)) other than passenger automobiles may only be combined with other listed property;
- (5) Assets for which the depreciation allowance for the placed-in-service year is not determined by using an optional depreciation table must be grouped into a separate multiple asset account or pool; and
- (6) Mass assets for which a mortality dispersion table is used to determine which assets have been disposed of must be grouped into a separate multiple asset account or pool.

*Mass assets* are a group of individual items of depreciable assets each of which is minor in value relative to the total value of the mass or group; numerous in quantity, usually accounted for only on a total dollar or quantity basis; with respect to which separate identification is impracticable; and placed in service in the same tax year.

### Effective Date

The temporary regulations pertaining to item and multiple asset accounts applies to tax years beginning on or after January 1, 2012 (Temp. Reg. §1.168(i)-7T(e)(2)).

## TAX PLANNING: USING A GAA AND GRANULAR DEFINITION OF AN ASSET FOR MAXIMUM TAX SAVINGS

Except for property described in Asset Classes 00.11 through 00.4 of Rev. Proc. 87-56 and in Code Sec. 168(e)(3), a taxpayer may use any reasonable and consistent method to treat each of the asset's components as the asset (Temp. Reg. §1.168(i)-1T(e)(2)(viii)(B)(6)). In the case of a building this means that a taxpayer can choose to treat components of structural components as the "asset." In the case of other property, such as a machine, a taxpayer can treat components of the machine as an "asset." Thus, when a component for a larger asset in a GAA is retired or sold the taxpayer may elect to treat the disposition as a qualifying disposition and recognize gain or loss by reference to the adjusted depreciable basis of the disposed of component at the time of disposition or, alternatively, follow the default rule and recognize no loss and treat the entire amount realized (if any) as ordinary income.

**Level of granularity.** The level of granularity chosen is important because of the rule in the temporary repair regulations that defines as a capitalized improvement the costs of replacing a component of a unit of property if a loss deduction is claimed on the replaced component or gain or loss is computed on the sale or exchange of the replaced component by reference to its adjusted depreciable basis. However, regardless of whether or not a loss deduction on the replaced component is claimed, an amount paid to replace a part or combination of parts that comprise a major component of a unit of property or a substantial structural part of a unit of property must be capitalized. Also, a taxpayer must capitalize the costs of repairing a property if a casualty loss is claimed (Temp. Reg. §1.263(a)-3T(i)(1)(iii)).

**Loss deduction versus repair.** A taxpayer's goal in nearly every situation should be to avoid claiming a loss deduction with respect to a replaced component if the replacement costs would otherwise be deductible as a repair. Conversely, if the cost of replacing a component must be capitalized for a reason other than claiming a loss on the replaced component a taxpayer will want to claim the loss deduction (assuming the effort and cost in determining the adjusted depreciable basis of the disposed of component relative to the amount of the loss makes it worthwhile).

A GAA in which a high level of component granularity is chosen for the property in the account will provide a taxpayer with the flexibility to achieve these goals. Specifically, in each situation where a component (asset) is retired a taxpayer may either follow the default "no loss" recognition rule (if the replacement costs are otherwise deductible as a repair expense) and take no action or, alternatively, elect to recognize a loss under the rules for qualifying dispositions if the replacement costs must be capitalized.

**CAUTION:** *For assets that are not in a GAA, a taxpayer must always recognize a loss when a component that is treated as an asset under the taxpayer's accounting method is retired. This rule militates against choosing a highly granular definition of a component for property that is not in a GAA.*

### Accounting Method Changes

Rev. Proc. 2012-20 adds new section 6.28 to the Appendix of Rev. Proc. 2011-14 to provide the following automatic accounting method changes relating to item and multiple asset accounts:

- (1) Change from single asset accounting to multiple asset accounting or vice versa (Sec. 6.28);
- (2) Moving assets within one multiple asset account to another multiple asset account (Sec. 6.28; and

- (3) Change in manner of identifying assets disposed of from a multiple asset account from one proper method to another proper method (Sec. 6.28).

## ACCOUNTING METHOD CHANGES

It is no exaggeration to say that virtually every business taxpayer will be required to file one or more automatic accounting method changes under Rev. Proc. 2012-19 and Rev. Proc. 2012-20 to comply with the temporary regulations. Consider, for example, that any taxpayer that owns a building and previously retired a structural component that it is currently depreciating will need to file an accounting method change to address the new rule which treats the retirement of a structural component as a disposition that generates a loss. Similarly any person who previously claimed a repair deduction for an amount that must be capitalized under the rules of the temporary regulations (or vice versa) must change its accounting method if the capitalized amount is or would not be fully depreciated. It also appears that a taxpayer must file an accounting method change to adopt the de minimis expensing rule unless an existing expensing policy completely comports with the rules in the temporary regulations. The IRS has been asked for clarification on this point.

**COMMENT:** *The IRS receives approximately 10,000–15,000 automatic change of accounting method requests per year. This number will increase dramatically for tax years beginning in 2012 and 2013. The ability of the IRS to handle this volume need not concern taxpayers, however, since an automatic change may be implemented so long as the IRS does not take affirmative action to deny the request.*

### Code Sec. 481(a) Adjustments

A change to comply with the temporary regulations is a change in accounting method and requires a Code Sec. 481(a) adjustment which is not applied on a cut-off basis except for those instances in which the effective date of the provision is for amounts paid to acquire or produce property in tax years begin-

ning on or after January 1, 2012. Most provisions are effective for tax years beginning on or after January 1, 2012 and require the computation of a section 481(a) adjustment.

**COMMENT:** *If a cut-off method applies a taxpayer continues to use its existing accounting method for amounts paid or incurred before the effective date and change its accounting method for amounts paid or incurred on or after the effective date.*

“Virtually every business taxpayer will be required to file one or more automatic accounting method changes ... to comply with the temporary regulations.”

Many of the accounting method changes allow the computation of a section 481(a) adjustment using a statistical sampling technique that is authorized by Rev. Proc. 2011-42. The IRS has informally indicated that a statistical sampling technique not specifically authorized by Rev. Proc. 2011-42 may be used if IRS permission is obtained, for example, in an audit.

**COMMENT:** *Generally, a negative (taxpayer favorable) section 481(a) adjustment that decreases taxable income is taken into account in a single tax year. Positive adjustments that increase taxable income are accounted for over four tax years.*

### Amended Return Option for MACRS Regulations

The temporary MACRS regulations contain a special rule that applies to assets placed in service in tax years ending before December 30, 2003. A taxpayer may treat a change to comply with the temporary MACRS regulations for some or all of such assets as a

change that is *not* a change in accounting method. This means that no Code Sec. 481(a) adjustment (or a similar cumulative depreciation adjustment) is required or permitted. A taxpayer who follows this treatment must file amended federal tax returns for any tax year that is open starting with the placed-in-service tax year (Rev. Proc. 2012-20, Section 5.01(2)). This amended return option only applies to the MACRS temporary regulations.

**CAUTION:** *The genesis of this rule can be traced to IRS Chief Counsel Notice CC-2004-007, January 28, 2004, as clarified by Chief Counsel Notice 2004-024, July 21, 2004. There the IRS announced that for property placed in service in a tax year ending before December 30, 2003 it would not assert that a change in computing depreciation is a change in accounting method. Thus, for such property a taxpayer is allowed to file amended returns for open years to claim the depreciation properly allowable in each open year. As mentioned earlier, in the context of a previously retired structural component, this option means that a taxpayer will remove the depreciation claimed on the retired component on the amended returns for open years and also reduce the basis of the building by the adjusted depreciable basis of the retired component without claiming the benefit of the loss deduction that is permitted if an accounting method change is instead filed.*

### General Rules for Rev. Procs. 2012-19 and 2012-20

The following general rules apply to all accounting method changes provided for in Rev. Proc. 2011-19 and Rev. Proc. 2012-20.

**Scope of limitations waived.** The scope of limitations in section 4.02 of Rev. Proc. 2011-14 is waived if a change is made for a taxpayer's first or second tax year beginning after December 31, 2012. These limitations, for example, prevent a taxpayer from filing an automatic method change



if it currently under examination, the taxpayer made or requested an accounting method change for the same item in the five-year period ending with the year of the proposed change, or the taxpayer is ceasing business operations in the year of the change.

**IMPACT:** *The waiver of the 5-year rule means that a taxpayer can file a second accounting method request under Rev. Proc. 2012-19 or Rev. Proc. 2012-20 in 2013 for an item which was changed in 2012 to correct errors or omissions in the 2012 Form 3115 filing.*

**Ogden copy required.** A signed copy of each completed Form 3115 should be filed

with the IRS in Ogden Utah in lieu of the national office copy no earlier than the first day of the first tax year of change and no later than the date the original Form 3115 is filed with the federal return for the year of change.

**Multiple changes on single Form 3115.**

A taxpayer is allowed to file a single Form 3115 for specified related changes made under Rev. Proc. 2012-20 and a single Form 3115 for specified related changes made under Rev. Proc. 2012-19. Some of these concurrent changes, however, may only be made in a taxpayer's first or second tax year ending after December 31, 2011. Thereafter, separate Forms 3115 for these changes must be filed.

**Change to comply with UNICAP rules.** A taxpayer who is not in compliance with the uniform capitalization (UNICAP) rules of Code Sec. 263A with respect to amounts for which an accounting method change is requested may not utilize the automatic consent procedures unless a concurrent change to comply with the UNICAP requirements is made. The scope of limitations is also waived for two years for this concurrent change.

**COMMENT:** *The instructions to Form 3115 have been updated to reflect the accounting method changes authorized by Rev. Proc. 2012-19 and Rev. Proc. 2012-20. It was not necessary to update the form.*

## REV. PROC. 2012-19—ACCOUNTING METHOD CHANGES RELATING TO CAPITALIZATION AND REPAIR

Change No.	Section added to Rev. Proc. 2011-14	General Topic	Specific Purpose	Section 481(a) Adjustment	Statistical Sampling	Related Regulation
162	3.10(1)(a)	Deducting Repair and Maintenance Costs	Change from capitalizing to deducting as repairs amounts paid for tangible property	YES	YES	1.162-4T
162	3.10(1)(a)		Change in definition of unit of property	YES	YES	1.263(a)-3T(e)
163	3.11(1)(a)	Regulated Taxpayers	Change to regulatory accounting method	YES	YES	1.263(a)-3T(k)
164	3.12(1)(a)	Materials and Supplies	Change to comply with definition of non-incidentals materials and supplies and deduct in year used or consumed	Cut-Off	YES	1.162-3T
165	3.13(1)(a)		Change to comply with definition of incidental materials and supplies and deduct in year paid or incurred	Cut-Off	YES	1.162-3T
166	3.14(1)(a)	Rotable Spare Parts	Change to deduct cost of non-incidentals rotables in tax year of disposition	Cut-Off	YES	1.162-3T
167	3.15(1)(a)		Change to optional method of accounting for rotatable spare parts	YES	YES	1.162-3T(e)
168	3.16(1)(a)	Dealer Expenses - Sales of Property	Change to treat commissions, etc., that facilitate sale of property as ordinary business expenses	YES	NO	1.263(a)-1T(d)(1)
169	3.17(1)(a)	De Minimis Expensing	Change to de minimis expensing rule	Cut-Off	NO	1.263(a)-2T(g)
170	3.18(1)(a)(i)	Investigation Costs - Acquisition of Real Property	Change from capitalizing to deducting amounts incurred to investigate acquisition of real property	Cut-Off	NO	1.263(a)-2T(f)(2)(iii)
170	3.18(1)(a)(ii)		Change from capitalizing to deducting employee compensation and overhead costs incurred to investigate acquisition of real property	Cut-Off	NO	1.263(a)-2T(f)(2)(iv)
171	3.19(1)(a)	Routine Maintenance Safe Harbor	Change to routine safe harbor maintenance method	YES	YES	1.263(a)-3T(g)
172	10.08(1)(a)	Non-Dealer Expenses - Sales of Property	Change to treat commissions, etc., that facilitate sale of property as capital expenditure	YES	NO	1.263(a)-1T(d)(1)
173	10.09(1)(a)	Capitalization of Acquisition and Production Costs	Change to capitalize amounts paid to acquire or produce property under Reg. Sec. 1.263(a)-2T, including defense of title and transaction costs	YES	YES	1.263(a)-2T
174	10.10(1)(a)	Capitalizing Improvements to Tangible Property	Change to capitalize amounts paid for improvements to units of property consistent with Reg. Sec. 1.263(a)-1T and 1.263(a)-3T	YES	YES	1.263(a)-1T; 1.263(a)-3T

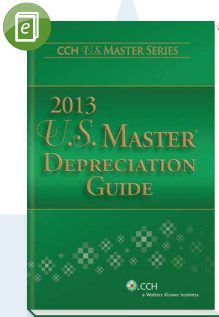
\*Cut-off method applies to amounts paid or incurred (for the acquisition or production of property) in tax years beginning on or after January 1, 2012

## REV PROC. 2012-20—ACCOUNTING METHOD CHANGES RELATING TO DEPRECIATION

Change No.	Section added to Rev. Proc. 2011-14	General Topic	Specific Change	Section 481(a) Adjustment	Statistical Sampling	Related Regulation
175	6.27(1)(a)	Depreciation of leasehold improvements	Change from improperly depreciating leasehold improvements under Code Secs. 167, 168, or 197 to properly depreciating	YES	NO	1.167(a)-4T
176	6.28(3)(a)(i)	Permissible to Permissible method of accounting for depreciation of MACRS property	Change from single asset accounting to multiple asset accounting or vice versa	modified cut-off	NO	1.168(i)-7T
176	6.28(3)(a)(ii) and (b)(i)		Moving assets within one multiple asset account to another multiple asset account or from one GAA account to another GAA account	modified cut-off	NO	1.168(i)-7T(c) 1.168(i)-1T(c)
176	6.28(a)(3)(iii)-(viii) and (b)(3)(ii)-(vii)		Change in manner of identifying assets disposed of from a multiple asset account or a multiple asset GAA account from one proper method to another proper method	YES*	NO	1.168(i)-8T(f)(1) and (2); 1.168(i)-1T(j)(2)
177	6.29(3)(a)	Buildings or structural components not in a GAA	A change to identify the appropriate asset disposed of	YES	YES	1.168(i)-8T(c)(4)
177	6.29(3)(b) or (c)		A change from capitalizing an asset previously disposed of (e.g. structural component) to recognizing gain or loss	YES	YES	NA
177	6.29(3)(d)		A change from improper method of identifying assets disposed of from multiple asset account (e.g., LIFO) to a proper method	YES	YES	1.168(i)-1T(f)(1) and (2)
178	6.30(3)(a)	Section 1245 property and land improvements not in a GAA	A change to identify the appropriate asset disposed of	YES	YES	1.168(i)-8T(c)(4)
178	6.30(3)(b) or (c)		A change from capitalizing an asset previously disposed of to recognizing gain or loss	YES	YES	NA
178	6.30(3)(d)		A change from improper method of identifying assets disposed of from multiple asset account (e.g., LIFO) to a proper method	YES	YES	1.168(i)-(f)(1) and (2)
179	6.31(3)(a)	Dispositions from GAA	A change to identify the appropriate asset disposed of	YES	NO	1.168(i)-1T(e)(2)(viii)
179	6.31(3)(b)		A change from improper method of identifying assets disposed of from GAA (e.g., LIFO) to a proper method	YES	NO	1.168(i)-1T(j)(2)
180	6.32(1)(a)(i)	General Asset Account Elections	Late GAA election for assets placed in service in tax years beginning before 2012	modified cut-off (if election is for assets owned at beginning of tax year)	NO	1.168(i)-1T(l)
180	6.32(1)(a)(ii)		Late election to recognize gain or loss on disposition of all assets or last asset in GAA	YES	NO	1.168(i)-1T(e)(3)(ii)
180	6.32(1)(a)(iii)		Late election to recognize gain or loss in a qualifying GAA disposition	YES	NO	1.168(i)-1T(e)(3)(iii)

\*Cut off method applies to change from specific identification method to (1) FIFO or modified FIFO method or (2) use of mortality dispersion table

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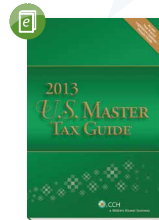
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