

Repair Regulations



The “Big” Picture

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CPAs & BUSINESS ADVISORS



Agenda

- Introduction
- What to Forget About (Temporary to Final)
- What You Need to Know
- Overview
 - De Minimis Rule
 - Unit of Property
 - Improvement Standards
 - Dispositions
 - Safe Harbors
 - Materials and Supplies
 - Acquisition Costs
- Firm Communication



What the Repair Regulations Do

- They provide guidance (“Framework”) for treatment of expenditures related to fixed assets on purchase, use, and disposal.
- Clarify the application and standards of sections 162(a) (deduction) and 263(a) (capitalization) to amounts paid to acquire, produce, or improve, or dispose of tangible property.
- Provide certain safe harbors (for example, the de minimis rule and routine maintenance).



Compliance Issues & Opportunities

- Compliance Issues
 - Annual Election Statements
 - Form 3115's (Still Waiting for Final Guidance)
 - Capitalization Policy
 - Systems to Capture Necessary Information
- Opportunities
 - De Minimis
 - Routine Safe Harbor
 - Dispositions
 - BAR Tests



Summary of Changes

Overview



What to Forget About

- GAA Accounts
- De Minimis Tests
 - 2% test (Based on depreciation)
 - .1% test (Gross Receipts)



Capitalization Rules

- Old Rules
 - Generally \$ driven
 - Clients did the account coding
 - Most significant building improvements were capitalized
- New Rules
 - Required capitalization if an item is:
 - More than \$200
 - Lasts more than 12 months
 - **Written capitalization policies**
 - Will increase tax return preparation time
 - More building repairs will be expensed



De Minimis Election

- De Minimis Election Generally Should Be Made
- Audited Financial Statements (AFS)
 - Substitute up to \$5,000 for the \$200
 - Capitalization policy must be in place at the beginning of the year
- Non-Audited Financial Statements
 - Substitute up to \$500 for the \$200
 - Capitalization policy must be in place at the beginning of the year
- Paid or Incurred vs. Placed-in-Service
- Consistency between Book & Tax



Capitalization Policy

Capitalization Policy

- Not defined in the Final Regulations
- A Capitalization Policy should have
 - Consistency and
 - An audited methodology for determining de minimis expenses.
- The greater the ambiguity, the greater chance of an examiner disallowing.

Repairs & Maintenance - General

- Less focus on the \$ amount
- Greater focus on the “what was done”
- Need to understand the “Unit of Property” Concept
- The “per item” on the invoice drives the capitalization
- More “significant building repairs & maintenance” will be expensed
- Class Life is important (Rev. Proc. 87-56)



Repairs & Maintenance (Cont.)

- Understanding the “BAR” tests
 - Betterment
 - Adaptation
 - Restoration
- No “Bright-Line” Tests
- Guidance provided by 190+ examples
- Need to understand the definition of
 - Major Component
 - Substantial Structural Part
 - Discrete & Critical Function

Deducting Building Repairs

- Must fail each of the “BAR” tests
- Understand what the component is that is being repaired
- Repair or Replacement of a building component: guidance provided by the 90+ examples
 - 0-30%: Deductible
 - 30-40%: In the “grey zone”
 - 40-100%: Capitalize



Examples: Discrete & Critical Function

Performs a discrete and critical function

- Roof
- Furnaces
- Chillers
- Roof Mounted HVAC units
- Sprinkler system
- Building wiring
- Toilets or Sinks
- Windows
- Floors

Examples: Major Components

Constitutes a major component:

- Whole roof;
- All chiller units;
- Whole sprinkler system;
- Whole building wiring;
- All toilets or sinks;
- 200 of 300 windows; and
- 40% of floors

Examples: Deductible Repairs

Does not constitute major components:

- Rubber membrane;
- 1 of 3 furnaces;
- 3 of 10 roof mounted HVAC units;
- 30% of building wiring;
- 8 of 20 (40%) sinks;
- 100 of 300 windows;
- 10% of floors; and
- 1 of 4 elevators



Examples: Substantial Structural Part

Constitute a substantial structural part:

- Whole Roof;
- Replacement of windows constituting 30% of surface area of the building;



Example: Substantial Structural Part

U owns a large office building that it uses to provide office space for employees that manage U's operations.

- The building has 300 exterior windows that represent 90 percent of the total surface area of the building.
- In Year 1, U pays an amount to replace 100 of the exterior windows that had become damaged.
- At the time of these replacements, U has no plans to replace any other windows in the near future.

Example: Restoration or Betterment?

Business decides to replace 100 light fixtures in the factory.

- Can no longer buy replacement bulbs for current ballasts
- Qualifies for energy rebates



Questions to Ask

- How many total lights in the factory?
 - 100 of 400
 - 100 of 100
- Are the new lights comparable to the original light?
 - Original lights were state of the art energy savers at the time of installation
 - Original lights were minimum required under the then current code
- What necessitated the replacement?
 - Cannot find bulbs
 - Energy savings
- How much savings will the new bulbs generate?

Optional Disposition Rules

- If capitalization is required under the “BAR” tests a “partial disposition deduction” is available
- Need to determine what the original cost of the component is that is being replaced
- Deduction claimed in year of disposition
- Election made by reporting the disposition on Form 4797
- Applicable to buildings

Elected Partial Dispositions

- For computing gain or loss, the adjusted basis of the disposed portion of the asset is the adjusted depreciable basis of that disposed portion at the time of its disposition.
- The taxpayer may use any reasonable method for purposes of determining the unadjusted depreciable basis of the disposed portion of the asset.
- Examples of a reasonable method include, but are not limited to:
 - Discounting the cost of the replacement portion of the asset to its placed-in-service year cost using the Consumer Price Index,
 - A pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed portion of the asset and the replacement cost of the asset, and
 - **A study** allocating the cost of the asset to its individual components.



Safe Harbors

- Routine Maintenance Safe Harbor
 - More than once during the class life
 - Building Class Life: 10-years
- Building Maintenance Safe Harbor
 - Cost of less than \$1,000,000
 - The lesser of 2% of cost or \$10,000
 - Ignore the BAR tests
 - Includes annual repairs, supplies, improvements



Compliance & Opportunities

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Takeaways

- Capitalization Policy
- De Minimis Elections
- Liberalization of Capitalization Standard
- Routine Maintenance Safe Harbor
- Dispositions and Partial Dispositions



Questions and Answers

