

Repairs and Improvements

Tangible Property Regulations

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What is Tangible Property?

- Physical Property
- **Depreciable** Tangible Property
 - Expense over time
- Repairs
 - Expense when occur
- Improvements
 - Expense over time

What You Need To Know

- Things have changed
- New definitions
- Benefits!
- Knowledge is Power

The Boring Stuff - History

- Tangible Property Regulations
 - 2003: IRS Notice 2004-6
 - 2011: Temporary Regulations
 - 2013: Final Regulations (T.D. 9636)
 - 2014: Additional Guidance (T.D. 9689)

The Final Regulations

- Applicable January 1, 2014
- Affect *all* taxpayers with tangible property
- Largest piece of tax legislation in decades.
- Simplify tangible property procedures
- Reg §1.263(a)-3

Why do we care?

- Compliance
 - We **all** want to follow the rules
- Tax Savings
 - “A nickel ain’t worth a dime anymore.”
- Capital Gains
 - No depreciation, no depreciation recapture!

The Old Ways...

- **Repairs and Maintenance**
 - “Expenses incurred for the purpose of keeping property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired.”

And now...

- **Repairs and Maintenance**
 - “Amounts paid for repairs and maintenance to tangible property are deductible *if* the amounts paid are not required to be capitalized under §1.263(a)-3”

The Old Ways...

- **Improvements**

- “Replacements, alterations, improvements, or additions that appreciably **prolong the life** of the property, materially **increase its value**, or make it adaptable to a different use.”

And now...

- **Improvements**

- “A taxpayer generally must capitalize the related amounts paid to **improve** a **unit of property** owned by the taxpayer.”

Improvements

- A **Unit of Property** is improved if the amounts paid for activities performed after the property is placed in service:
 - Are for a **Betterment** to the Unit of Property
 - **Restore** the Unit of Property
 - **Adapt** the Unit of Property to a new or different use.

New Questions

1. What is the “Unit of Property”?
 2. Is it a Betterment?
 3. Is it a Restoration?
 4. Is it an Adaptation?
- **What do these mean?!**

The Building Block – The Unit of Property

- “All components (real or personal property) that are functionally interdependent to one another.”
- Functionally interdependent
 - Can **not** place one in service without the other
 - Can **not** function alone
- Facts and Circumstances

Separate Units of Property



Unit of Property #1



Unit of Property #2

Single Unit of Property



**All Components:
One Unit of
Property**

Unit of Property - Building

1. Building and its structural components

2. Building Systems

- HVAC
- Plumbing
- Electrical
- Escalators
- Elevators
- Fire Protection & Alarms
- Security Systems
- Gas Distribution



Unit of Property: HVAC System

Unit of Property - Leasehold

- Landlord
 - Entire building and its structural components
 - Building systems
- Tenant
 - Portion of the building subject to lease
 - Structural systems associated with the leased portion

Betterment

1. Corrects a material preexisting condition or defect

- Exist **prior to** acquisition or production of the UOP
- **Material** in amount or nature
- Facts and Circumstances!



Also a Betterment

2. Is for a material addition

- Enlargement
- Expansion
- Extension
- Addition of major component
- Increase capacity



Absolutely a Betterment

3. Increases the productivity, efficiency, strength, quality, or output of the unit of property.



Not a Betterment

- Normal wear and tear
- Damage
- Unavailability of replacement parts



NOT a Betterment!

Restorations

- Returns the UOP to its ordinarily efficient operating condition.
 - State of disrepair
 - No longer functional
- Rebuilding of the UOP to a like-new condition
 - After end of class life



More Restorations

- Replacement of a part or combination of parts
 - Major component
 - Substantial structural part
- Replacement of a component
 - Deduct a loss
 - Gain or loss on sale or exchange
- Casualty Loss



Major Component Discrete Function Restoration

Adaptations

- Adapt a unit of property to a new or different use.
 - Not consistent with ordinary use at the time it was originally placed in service.
- Buildings
 - Must adapt the structure or building systems
 - Unit of Property

Special Rules for Improvements

- Indirect Costs
 - Repair: Expense
 - Improvement: Capitalize
- Removal Costs
 - Repair: Expense
 - Improvement: Capitalize



Capitalize if Improvement!

Relief!

- Safe Harbor for Routine Maintenance
- De Minimis Safe Harbor
- Safe Harbor for Small Taxpayers

Safe Harbor for Routine Maintenance

- Activities performed to keep property in its ordinary efficient operating condition.
- Inspection, cleaning, testing, replacement of parts, other recurring activities
- Occurs more than once during the asset's class life
- Buildings – occurs more than once in a 10 year period.



Expected Life: 5 years, 6,000 hours

Paint: 3,000 hours

Tires: 1,200 hours

Hydraulic System: 3,000 hours

Transmission: 3,000 hours

Routine Maintenance!

De Minimis Safe Harbor

- Deduction of *any* tangible property
- Applicable Financial Statement (AFS)
 - Audited
 - Required by SEC
 - Required by Government Agency (not IRS)

De Minimis Safe Harbor

- AFS
 - \$5,000 Safe Harbor
- No AFS
 - \$500 Safe Harbor
- Consistent Company Policy
- Annual Election

Safe Harbor for Small Taxpayers

- Small Taxpayer
 - \$10,000,000 average gross receipts for the preceding 3 years
- Eligible Building Property
 - \$1 million unadjusted basis
- Costs may not exceed, in aggregate, the lessor of:
 - \$10,000
 - 2% of the property's unadjusted basis



Unadjusted Basis

- \$750,000

Repairs & Improvements

- \$10,000

Safe Harbor!!!

Repairs & Improvements

- \$10,500

I-BAR

Necessary Steps

1. Does it qualify for relief?
 - a. Under your safe harbor threshold?
 - b. Routine in nature?
 - ✓ Yes? **STOP!** Expense it!
2. Determine your Unit of Property.
 - a. Functionally interdependent

Necessary Steps (Continued)

3. Is it an Improvement?

a. Betterment

- Pre-existing condition
- Material addition
- Increase productivity, efficiency, etc.

b. Restoration

- Like-new condition

c. Adaptation to new use

✓ No? Expense it!

Final Thoughts

- What about GAAP?!
 - Expense for Tax, Capitalize for GAAP
 - Does **not** apply to the De Minimis Safe Harbor
- This is a good thing!
 - Tax friendly

Thank You!