2014

CCH® FEDERAL TAX PERSPECTIVES

Update To Final Repair/Capitalization/ MACRS Regulations

GIBBONS&KAWASH

Certified Public Accountants

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Introduction

After several years of contentious struggle, the IRS at long last completed its "repair regulations" project, including the closely related Modified Accelerated Cost Recovery System (MACRS) project dealing with dispositions of MACRS property and MACRS general asset, multiple asset, and item accounts.

In addition to finalizing all temporary and proposed regulations related to these two projects, the IRS also completed guidance related to accounting method changes that must be filed to comply with accounting methods described in the final regulations in situations where a taxpayer's current accounting method is different than a method allowed by the final regulations.

Overall, the final repair regulations are substantially unchanged from the temporary regulations, but there are a few favorable surprises, such as a revised de minimis safe harbor and the extension of the routine maintenance safe harbor to buildings. Also, in response to a chorus of criticism from virtually every quarter, the final MACRS regulations eliminate a key feature of the temporary regulations that made the recognition of loss on the retirement of a structural component elective only if the building was placed in a general asset account (GAA).

Taxpayers who made a GAA election in reliance on the temporary regulations are allowed to revoke those elections by filing an accounting method change for the 2013 or 2014 tax year.

Furthermore, taxpayers who filed accounting method changes to claim retirement losses on structural components under the rules in the temporary regulations for buildings in GAAs and outside of GAAs will need to file a late partial disposition election accounting method change to preserve those losses. The same holds true for retirement losses claimed on section 1245 property and components of section 1245 property in a multi-asset GAA account and in certain cases components of section 1245 property outside of a GAA account.

WHAT'S CHANGED?

Changes to the temporary repair regulations were made to "clarify, simplify, and refine," as well as to create several new safe harbors. The most significant changes include:

- A revised and simplified de minimis safe harbor under Reg. §1.263(a)-1(f);
- The extension of the safe harbor for routine maintenance to buildings;
- A new annual election for smaller taxpayers to deduct some improvement costs for buildings;
- A new annual election to capitalize repair costs that are capitalized on the taxpayer's books and records; and
- Refined criteria for defining betterments and restorations to tangible property.

The final MACRS regulations adopt rules relating to dispositions of MACRS property and accounting for MACRS property in item, multiple asset, and general asset accounts.

> **COMMENT.** Under the temporary regulations on dispositions (Temp. Reg. §1.168(i)-8T) and general asset accounts (Temp. Reg. §1.168(i)-1T), retirements of structural components resulted in recognition of a loss unless the taxpayer placed the building in a GAA. Recognition of loss on a retired structural component in a GAA, on the other hand, was elective. These temporary regulations were withdrawn and re-proposed to make the recognition of loss on the retirement of a structural component outside of a GAA elective (the "partial disposition" election) and to prohibit the recognition of a loss on a structural component retirement if the building is in a GAA. The proposed regulations were finalized without change. To take advantage of the election under the temporary GAA rules, many taxpayers made retroactive elections to place buildings in a GAA under the guidance of Rev. Proc. 2012-19 (IRB 2012-14, 689). Such taxpayers will generally want to filing accounting method changes to revoke these elections in order to claim future retirement losses on structural components and to preserve retirement losses that may have been claimed while the building was in the GAA. Taxpayers will also be allowed to file an accounting method change to make a late partial disposition election for partial dispositions that took place in tax years beginning before January 1, 2012 with respect to assets that are not in a GAA or assets that were removed from a GAA by reason of revoking the GAA election.

Overview

ORGANIZATION OF FINAL REGS

The key final repair regulations are organized as follows:

- Materials and supplies (Reg. §1.162-3);
- De minimis safe harbor (Reg. §1.263(a)-1(f));
- Amounts paid for the acquisition or production of tangible property (Reg. §1.263(a)-2); and
- Amounts paid for the improvement of tangible property (capitalization v. repair) (Reg. §1.263(a)-3).

The final MACRS regulations cover:

- General asset accounts (Reg. §1.168(i)-1);
- Item and pool accounting (Reg. §1.168(i)-7); and
- Dispositions (Reg. §1.168(i)-8).

EFFECTIVE DATES

The final repair and final MACRS regulations must be followed by all taxpayers starting in tax years beginning on or after January 1, 2014. However, the final regulations may (at a taxpayer's discretion) be applied to a tax year beginning on or after January 1, 2012, and before January 1, 2014.

Taxpayers were also allowed to apply temporary repair regulations and temporary or proposed MACRS regulations to tax years beginning on or after January 1, 2012 and before January 1, 2014 if desired.

ACCOUNTING METHOD CHANGES

The IRS issued Rev. Proc. 2014-16 to provide procedures for automatic changes to an accounting method required or permitted by the final repair regulations, effective for applications filed after January 24, 2014. This procedure also applies for applications filed after January 24, 2014, to make

a change under the temporary repair regulations for a tax year beginning on or after January 1, 2012, and before January 1, 2014. Filing under the temporary regulations, however, is now likely to be rare since most taxpayers for whom the filing deadline has not expired will prefer to adopt the final regulations during this period. Moreover, any changes filed under the temporary regulations that provide an accounting method that is inconsistent with the accounting method required under the final regulations need to be refiled under the final regulations for the 2014 tax year.

Rev. Proc. 2012-19 provided the automatic consent procedures for changing to an accounting method under the temporary repair regulations for a tax year beginning on or after January 1, 2012, and before January 1, 2014, if the application was filed on or before January 24, 2014. Rev. Proc. 2014-16 supersedes Rev. Proc. 2012-19 effective January 24, 2014.

Rev. Proc. 2014-54 (IRB 2014-41, 675) provides accounting method changes to comply with the final MACRS regulations, effective for changes filed on or after September 18, 2014.

Effective February 28, 2014, accounting method changes to change to a method in the temporary or proposed MACRS regulations in a tax year beginning on or after January 1, 2012 and before January 1, 2014 are filed under Rev. Proc. 2014-17, as modified by Rev. Proc. 2014-54.

Rev. Proc. 2012-20 (IRB 2012-14, 700) provided the automatic accounting method change procedure under the temporary MACRS regulations prior to February 28, 2014. Rev. Proc. 2012-20 is modified and superseded by Rev. Proc. 2014-17, effective February 28, 2014.

Accounting method changes are discussed in greater detail later in this e-book.

CCH IN-DEPTH COVERAGE

The following table shows where the final regulations and the procedures for changing accounting methods are discussed in the Standard Federal Tax Reporter and the Tax Research Consultant.

Final and Proposed Regulations by Subject	Regulation Citation	CCH Standard Federal Tax Reporter Discussion	CCH Tax Research Consultant Discussion
Materials and supplies	Reg. §1.162-3	¶8610.01 - ¶8610.05	BUSEXP: 18,558
MACRS general asset accounts	Prop. Reg. §1.168(i)-1	¶11279.038	DEPR: 3,559
MACRS item and multiple asset accounts	Reg. §1.168(i)-7	¶11279.0372	DEPR: 15,210

Final and Proposed Regulations by Subject	Regulation Citation	CCH Standard Federal Tax Reporter Discussion	CCH Tax Research Consultant Discussion
Dispositions of MACRS property	Prop. Reg. §1.168(i)-8	¶11279.0373	DEPR: 15,210
Partial disposition election	Prop. Reg. §1.168(i)-8(d)	¶11279.0373	DEPR: 15,210
Amounts paid to acquire or produce tangible property	Reg. §1.263(a)-2	¶13709.012 - ¶13709.0126	BUSEXP: 9,080
Amounts paid to improve tangible property	Reg. §1.263(a)-3	¶13,709.013 - ¶13,709.0139	BUSEXP: 9,090 - 9,099
Unit of property	Reg. §1.263(a)-3(e)	¶13,709.01342 - ¶13,709.01344	BUSEXP: 9,094
De minimis safe harbor	Reg. §1.263(a)-1(f)	¶13,709.0124	BUSEXP: 9,104.15
Routine maintenance safe harbor	Reg. §1.263(a)-3(i)	¶13,709.01362	BUSEXP: 9,096.10
Small taxpayer building safe harbor	Reg. §1.263(a)-3(h)	¶13,709.01363	BUSEXP: 9,096.20
Book conformity safe Harbor	Reg. §1.263(a)-3(n)	¶13,709.01361	BUSEXP: 9,096.25
Regulatory accounting method safe harbor	Reg. §1.263(a)-3(m)	¶13,709.01364	BUSEXP: 9,096.15
Accounting Method Changes -Rev. Proc. 2014-54	MACRS regulations	¶11,043.023	DEPR: 15,304.30 et seq.

1. Materials And Supplies

KEY CHANGES TO TEMPORARY REGULATIONS:

- $100 per-item threshold for materials and supplies is increased to $200.
- Standby emergency spare parts are included in definition of material and supplies.
- Election to capitalize materials and supplies now limited to rotable, temporary, and standby emergency spare parts.
- Materials and supplies are subject to de minimis safe harbor.

GENERAL RULES FOR MATERIALS AND SUPPLIES

Under the final repair regulations, the cost of acquiring material and supplies is generally deducted in the tax year the materials or supplies are first used or consumed (Reg. §1.162-3(a)(1)). Gain on the disposition of a material or supply is ordinary income (Reg. §1.162-3(g)).

Incidental materials and supplies are deducted in the tax year their cost is paid or incurred provided taxable income is clearly reflected (Reg. §1.162-3(a)(2)). 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 beginning and ending inventories are not taken.

Materials and supplies that are used in the production of property are subject to the uniform capitalization rules of Code Sec. 263A (Reg. §1.162-3(b)). For example, amounts paid for materials and supplies used in the production of inventory or a self-constructed asset generally are required to be capitalized under section 263A. Similarly, amounts paid to produce materials and supplies generally are required to be capitalized as part of the production costs of the materials and supplies.

A "material and supply" is defined as tangible property that (1) is used or consumed in the taxpayer's business operations, (2) is not inventory, and (3) falls into one of these categories:

- A unit of property with an acquisition or production cost of less than $200;

- A component that is 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; or
- Any other tangible property identified in IRS guidance as a material or supply (Reg. §1.162-3(c)(1)).

The IRS clarified that prior published guidance that permits certain property to be treated as materials and supplies remains in effect. For example, materials and supplies may include restaurant smallwares described in Rev. Proc. 2002-12 (2002-1 CB 374) and certain inventoriable items of small businesses described in Rev. Proc. 2002-28 (2002-1 CB 815).

IMPACT. The IRS increased the acquisition or production cost threshold for a unit of property to be considered a material or supply from $100 to $200, as was suggested by many commentators. However, a taxpayer electing the revised de minimis safe harbor expensing rule discussed below may claim a current deduction for a unit of property or material and supply costing $500 or less ($5,000 or less for taxpayers with an applicable financial statement) if certain requirements are met.

CAUTION! Materials and supplies are defined to include components acquired to"improve" a unit of property. Nevertheless, the repair regulations provide that materials and supplies used to improve property are not treated as materials and supplies and must be capitalized and depreciated as part of the cost of the improvement, rather than deducted in the year used or consumed (Reg. §1.263(a)-3(c)(2)). This implies that a taxpayer should keep track of the ultimate use of its materials and supplies, including non-incidental materials and supplies.

EXAMPLE. Lumber (a component) is used to improve a building structure (a unit of property). Even though the lumber is a component used to improve another unit of property, its cost may not be deducted in the year used or consumed, but instead is capitalized (along with other related improvement costs) and depreciated as an improvement.

Moreover, the Uniform Capitalization Rules would also likely require capitalization of the lumber costs, since production activities for purposes of the UNICAP rules also include the improvement of a property.

Grey Area

The regulations, if strictly applied, require a taxpayer to capitalize the cost of materials and supplies used to improve a unit of property even though the taxpayer previously deducted the cost in the year paid or incurred (incidental materials and supplies) or in the year of original use or consumption (non-incidental materials and supplies). When a current deduction for a material amount that should be capitalized and depreciated is claimed, the taxpayer should correct the mistake through an amended return if two returns have not been filed. If two returns have been filed, the improper deduction constitutes an accounting method that should be corrected via a change in accounting method under the automatic procedure of Rev. Proc. 2014-16. However, the IRS should not require a taxpayer to make the correction if the amounts at issue are immaterial or, arguably, if at the time of the deduction there was no reasonable expectation that the materials and supplies would be used to improve a property.

COMMENT. The preamble to T.D. 9636 indicates if property is acquired without the expectation of being used in the production of property and the taxpayer deducts the cost under the de minimis safe harbor rule, the uniform capitalization rules will not require capitalization of the cost of the property even if expectations change and it is later used in the production of property.

STANDBY EMERGENCY SPARE PARTS

The final regulations provide that "standby emergency parts" are materials and supplies that are deductible in the year used or consumed. Previous IRS guidance required taxpayers to capitalize and depreciate these parts (Rev. Rul. 81-185, 1981-2 CB 59). The temporary regulations did not address the treatment of standby parts.

CAUTION! The rule described below that treats rotable and temporary spare parts as used or consumed in the year they are discarded does not apply to standby emergency parts (Reg. §1.162-3(a)(3)).

Borrowing from a description in Rev. Rul. 81-185, relating to an emergency generator located at a power plant, the final regulations define a

standby emergency part as a component of a particular item of machinery or equipment set aside for use as a replacement to avoid substantial operational time loss caused by emergencies due to failure of the replaced part. The part must be relatively expensive, directly related to the machinery or equipment it services, available only on special order (i.e., not readily available from a vendor or manufacturer), and not subject to normal periodic replacement. Generally, only one standby emergency part may be on hand for each piece of machinery or equipment (Reg. §1.162-3(c)(3)).

> **CAUTION!** Standby emergency parts do not qualify as rotable spare parts because standby emergency parts are not rotated in and out of service.

> **COMPLIANCE NOTE.** Under Rev. Rul. 81-185, a standby emergency part is not a material or supply, but is capitalized and depreciated in the year acquired. See, also, Rev. Rul. 69-201 (1969-1 CB 60). In contrast, the final regulations treat a standby emergency part as a material or supply that is deductible in the year used or consumed. However, as explained below, the final regulations allow a taxpayer to elect to capitalize and depreciate a standby emergency spare part in the year acquired. Consequently, an electing taxpayer can continue to capitalize and depreciate its standby emergency parts in accordance with Rev. Rul. 81-85.

ROTABLE AND TEMPORARY SPARE PARTS

The final regulations retain the general rule that rotable and temporary spare parts are materials and supplies that are deducted in the year used or consumed unless the taxpayer elects the optional method of accounting (Reg. §1.162-3(c)).

A special rule provides that a rotable or temporary spare part is considered used or consumed in the tax year that it is disposed of (Reg. §1.162-3(a)(3)). A standby emergency spare part is considered used or consumed when it is installed.

> **COMMENT.** The treatment of rotable and temporary spare parts as materials and supplies under the final regulations is inconsistent with prior rulings that treat such parts as depreciable assets (e.g., Rev. Rul. 2003-37, 2003-1 CB 717; Rev. Rul. 69-200, 1969-1 CB 60). However, the final regulations resolve this inconsistency by allowing a taxpayer to elect to capitalize and depreciate rotable and temporary spare parts in the year acquired as explained below.

A rotable spare part is a component that is installed on a unit of property owned, leased, or serviced by the taxpayer, and is later removed from the property, repaired or improved, and then either reinstalled on the same or other property or stored for later installation. Temporary spare parts are components that are used temporarily until a new or repaired part can be installed, and then are removed and stored for later installation (Reg. §1.162-3(c)(2)).

COMMENT. The IRS rejected a recommendation to expand the definition of rotable and temporary spare parts to include spare parts leased in the ordinary course of a taxpayer's leasing business.

OPTIONAL METHOD OF ACCOUNTING

Rather than deducting the cost of a rotable or temporary spare part in the tax year that the part is discarded, a taxpayer may use an optional method and deduct the cost when the part is first installed (Reg. Sec. §1.162-3(e)).

The optional method does not apply to stand-by emergency parts.

Under the optional method, a taxpayer deducts the cost in the tax year the part is originally installed. When the part is removed, the taxpayer includes the fair market value (FMV) of the part in gross income, and increases the basis of the part ($0 since the cost was fully deducted) by the FMV included in income plus the cost of removing the part, as well as any amount paid or incurred to repair, maintain, or improve the part after removal. When the part is reinstalled, the basis is deducted along with reinstallation costs. This cycle is followed for each reinstallation.

The basis of a rotable or temporary spare part may be deducted when it is discarded.

IMPACT. The optional method requires complex record-keeping but the pay-off is a deduction in the installation year rather than the later discard year. For taxpayers that do not want to use the optional method, the election to capitalize and depreciate (described below) offers another good alternative to claiming a deduction in the disposition year.

The optional method is not an election. A taxpayer that uses the method must apply it to all pools of rotable and temporary spare parts in the same trade or business or, alternatively, to all pools for which the taxpayer uses the optional method in its own books and records. This rule is applied separately to each of the taxpayer's trades or businesses (Reg. §1.162-3(e)(1)).

COMPLIANCE NOTE. The temporary regulations required the optional method to be used for all of a taxpayer's rotable and temporary spare parts in the same trade or business. The final regulations now also allow a taxpayer to follow its book method.

ELECTION TO CAPITALIZE AND DEPRECIATE ROTABLE, TEMPORARY, AND STANDBY PARTS

The temporary regulations generally allowed a taxpayer to elect to capitalize and depreciate any type of material and supply other than rotable and temporary spare parts for which the optional method was elected (Temp. Reg. §1.162-3(d)).

The final regulations restrict the capitalization election to rotable and temporary spare parts for which the optional method is not elected and to standby emergency spare parts (Reg. §1.162-3(d)). The election also does not apply to a rotable, temporary, or emergency spare part that will be used as a component of a material or supply that is a unit of property costing less than $200, or a component of a unit of property with an economic useful life of less than 12 months.

No special form or statement is required to make the election to capitalize and depreciate rotable, temporary, and standby emergency parts. Instead, the taxpayer simply claims a depreciation deduction for the affected spare parts on a timely filed original return (including extensions) for the tax year the asset is placed in service. The election is made by a partnership or S corporation and not by the partners or shareholders. The election applies on a part-by-part basis and does not need to be made for all of a taxpayer's eligible rotable, temporary, or standby emergency parts (Reg. §1.162-3(d)(3)).

COMPLIANCE NOTE. The IRS issued corrections to the final repair regulations which clarify that a taxpayer must depreciate the rotable, temporary, or standby part to which the capitalization election applies. Also, the election cannot be made with respect to an asset (or portion of an asset) that is placed in service and disposed of in the same tax year. The clarifications also apply to elections under the temporary regulations (Reg. §1.162-3(d) and (j)(3), as corrected on July 21, 2014).

A rotable, temporary, or standby emergency spare part is placed in service when acquired (Rev. Rul. 2003-37; Rev. Rul. 69-200).

The election to capitalize and depreciate may be revoked only by filing a request for a letter ruling that grants IRS consent to revoke the election. The

taxpayer must have acted reasonably and in good faith, and the revocation must not prejudice the interests of the government.

CAUTION! A taxpayer may not dispose of a capitalized part by transferring it to a supplies account unless the taxpayer first obtains consent to revoke the election (Reg. §1.168(i)-8(c)(2)).

Amended 2012 or 2013 returns—If a taxpayer wanted to make the election to capitalize and depreciate rotable, temporary, or standby emergency spare parts for a tax year beginning on or after January 1, 2012, and ending on or before September 19, 2013, but did not do so on its timely filed original return, the final regulations allowed a taxpayer to make the election by filing an amended return within 180 days from the due date, including extensions (even if no extension was requested), of the taxpayer's tax return for the year of the election (Reg. §1.162-3(j)(2)).

COORDINATION WITH *DE MINIMIS* SAFE HARBOR

Materials and supplies were not deductible under the de minimis safe harbor provided by the temporary regulations except to the extent that a taxpayer elected to make them subject to the safe harbor. The final regulations require a taxpayer electing the de minimis safe harbor to apply the safe harbor to amounts paid for all materials and supplies that meet the requirements, including the $500 or $5,000 de minimis per item limit, for deduction under the safe harbor. The requirement does not apply to rotable, temporary, and standby parts that the taxpayer elects to capitalize and depreciate or rotable and temporary spare parts for which the taxpayer properly uses the optional method of accounting (Reg. §1.162-3(f)).

COMPLIANCE NOTE. The cost of materials and supplies is usually deducted in the year used or consumed. Under the safe harbor, the cost of the de minimis items is deducted in the year paid or incurred.

ACCOUNTING METHOD CHANGES

A change to comply with the final regulations relating to materials and supplies is a change in method of accounting (Reg. §1.162-3(i)).

Rev. Proc. 2014-16 provides for the following specific changes relating to materials and supplies.

- Change to deducting the cost of non-incidental materials and supplies to the year used or consumed (change 186)
- Change to deducting the cost of incidental materials and supplies to the year paid or incurred (change 187)
- Change to deducting the cost of non-incidental rotable and temporary spare parts to the year disposed of (change 188)
- Change to the optional method for rotable and temporary spare parts (change 189)

The first three methods are "paid or incurred" methods that require the calculation of a modified Code Sec. 481(a) adjustment. Therefore, if the change is made in the 2014 tax year, no adjustment is required. The optional accounting method for rotable and temporary spare parts requires the computation of a full Code Sec. 481(a) adjustment.

The election to capitalize and depreciate rotable, temporary, and emergency spare parts is not an accounting method (Reg. §1.162-3(d)(3)).

COMMENT. Most taxpayers do not have an accounting method that deducts non-incidental materials and supplies in the year used or consumed. Consequently, the IRS has indicated that it expects most taxpayers to file an accounting method change to switch to the required method of deducting materials and supplies when used or consumed.

2. *De Minimis* Safe Harbor Election

KEY CHANGES TO TEMPORARY REGULATIONS:

- Ceiling limitation is replaced with $500/$5,000 per-item limit.
- Taxpayers without applicable financial statement (AFS) qualify.
- Safe harbor is an election and not an accounting method.
- No election to exclude materials and supplies.

GENERAL RULES FOR *DE MINIMIS* SAFE HARBOR ELECTION

The final regulations make taxpayer-friendly changes to the de minimis expensing rule originally provided in the temporary repair regulations (Reg. §1.263(a)-1(f)).

Most significantly, the overall ceiling on the amount deductible under the de minimis rule is eliminated and replaced with a per-item limitation of $5,000 for taxpayers with an applicable financial statement (AFS) and a $500 per-item limitation for taxpayers without an AFS.

Under the temporary regulations, the de minimis rule did not apply to a taxpayer without an AFS (Temp. Reg. §1.263(a)-2T(g)).

> **COMMENT.** The IRS moved the de minimis rule from Temp. Reg. §1.263(a)-2T(g) to Reg. §1.263(a)-1(f).

Under the temporary regulations, the de minimis rule was not an election and was adopted by filing an accounting method change. Under the final regulations, the de minimis rule is an annual elective safe harbor and may not be adopted by filing an accounting method change.

As revised by the final regulations, the safe harbor provides that a taxpayer may not capitalize amounts paid (cash basis taxpayer) or incurred (accrual basis taxpayer) that cost less than a specified amount for:

- The acquisition of a unit of tangible property,
- The production of a unit of property, or
- Materials or supplies (Reg. §1.263(a)-1(f)(1)).

The per-item amount that may be expensed for tax purposes is limited to $5,000 per item for a taxpayer with an AFS and $500 per item for a taxpayer without an AFS.

The safe harbor does not apply to:

- Land,
- Amounts paid for property that is or is intended to be included in inventory,
- Rotable, temporary, and standby emergency spare parts that are capitalized and depreciated, and
- Rotable and temporary spare parts accounted for under the optional method of accounting for rotable parts (Reg. §1.263(a)-1(f)(2)).

ELIGIBLE TAXPAYERS

A taxpayer with an AFS may elect the safe harbor for a particular tax year only if:

1. The taxpayer has at the beginning of the tax year written accounting procedures that treat as an expense for non-tax purposes (a) amounts paid for property costing less than a specified dollar amount, or (b) amounts paid for property with an economic useful life of 12 months or less; and
2. The taxpayer treats the amount paid for the property as an expense on its AFS in accordance with its written accounting procedures (Reg. §1.263(a)-1(f)(1)(i)).

If the amount paid for the property exceeds $5,000 per invoice (or per item as substantiated by the invoice) then the amount paid is not deductible under the de minimis safe harbor (Reg. Sec. 1.263(a)-1(f)(1)(i)).

The same requirements apply to a taxpayer without an AFS with the following two differences:

1. The accounting procedure that must be in effect at the beginning of the tax year does not need to be written; and
2. The amount paid for property that exceeds $500 per invoice (or per item as substantiated by the invoice) is not deductible under the de minimis rule (Reg. §1.263(a)-1(f)(1)(ii)).

Even though many taxpayers did not have expensing policies in effect at the beginning of their 2012 or 2013 tax years, the IRS declined to grant transitional relief for taxpayers who would otherwise have been able to apply the de minimis rule.

PLANNING TIP. Although the accounting procedure in place at the beginning of the tax year does not need to be written if the taxpayer does not have an AFS, the best practice is to use a written policy. A written policy will go a long way in establishing that a policy was in effect and communicated to relevant employees. The CCH Election and Compliance Toolkit on IntelliConnect has sample written policies for taxpayers with and without an AFS.

The taxpayer's financial or book expensing policy may set a lower or higher per-item limit than the $500/$5,000 regulatory limit. If a lower limit is set, the lower limit also applies for tax purposes. If a higher limit is set, the tax deduction remains subject to the applicable $500 or $5,000 cap. The taxpayer's accounting policy can also set different limits for different types of property and provide specific exclusions.

The goal of these rules is to align tax and book expensing. For taxpayers with an AFS, standards applicable to the AFS should prevent a taxpayer from adopting an expensing policy that materially distorts taxable or book income. For taxpayers without an AFS, the $500 per item limit, in the IRS's view, operates to achieve this result.

COMMENT. In one of the few provisions in the final regulations that is more restrictive to taxpayers, the final regulations require that the de minimis safe harbor, if elected, be applied to all materials and supplies other than rotable and temporary spare parts to which the optional method is applied or rotable, temporary, and emergency spare parts for which an election to capitalize and depreciate is made (Reg. §1.162-3(f)). The IRS argued that doing so simplifies the application of the de minimis rule and reduces its administrative burden. The temporary regulations allowed the deduction of materials and supplies under the de minimis rule only if the taxpayer elected to apply the de minimis rule to the materials and supplies.

COMPLIANCE NOTE. If a taxpayer's expensing policy exceeds the applicable $500/$5,000 level, the taxpayer may still make the case with its IRS exam team that the greater amount is reasonable under the facts and circumstances because it does not materially distort income. The $500/ $5,000 limit is a safe harbor, rather than an absolute limit. Examining agents do not need to revise materiality thresholds already in place with a taxpayer to line up with the safe harbor limitations.

UNIT OF PROPERTY ACQUISITIONS

The de minimis safe harbor most typically applies to acquisitions of separate units of property that cost no more than the $500/$5,000 per item limit.

EXAMPLE. A taxpayer with a $500 per item book expensing limitation buys 1,000 calculators costing $100 each. The calculators are materials and supplies because each calculator is a unit of property costing $200 or less. If the de minimis safe harbor is elected, however, the taxpayer expenses the cost of the calculators in the year paid or incurred rather than in the year of use or consumption because the de minimis rule applies to all materials and supplies.

EXAMPLE. Assume the calculators cost $500 each. Although the calculators are not materials or supplies because they cost more than $200 each, the de minimis rule still applies because they are units of property with an acquisition cost that does not exceed $500. If the calculators cost $600 each, the de minimis rule does not apply and the cost of the calculators must be capitalized and depreciated.

The cost of acquiring a component of a unit of property is deductible under the de minimis rule if the component is a material or supply.

Components acquired to repair or improve a unit of property are materials and supplies regardless of cost and, therefore, are deductible under the de minimis rule in the year the cost is paid or incurred, so long as the cost of the component does not exceed the applicable per-item limit (usually $500 or $5,000).

EXAMPLE. ABC buys a steel beam to be used in a repair or improvement of a unit of property for $3,000. ABC has no AFS but has a book policy of expensing items costing $500 or less. The beam is a material or supply because it is a component used in the repair or improvement of a unit of property. The de minimis safe harbor does not apply to the beam because it costs more than the $500 limit. Therefore, its cost is deducted as a material or supply in the year used or consumed if it is a repair or capitalized if it is an improvement. If the beam costs less than the $500 limit, it is deductible under the de minimis rule in the year the cost was paid or incurred. If ABC has an AFS and a written book policy of expensing items costing $5,000 or less, the $3,000 cost is deductible in the year paid or incurred under the de minimis safe harbor.

Although materials and supplies are defined to include the cost of components used to repair, maintain, or improve a unit of property and are, therefore, eligible for deduction under the de minimis rule, such costs may need to be capitalized by reason of the uniform capitalization rules because the UNICAP rules apply to the direct and indirect costs of producing property (Code Sec. 263A(g)). For example, the cost of repairing equipment or facilities is an indirect cost required to be capitalized to the extent properly allocable to property produced or acquired for resale (Reg. §1.263A-1(e)(3)(ii)(O)). Note also, as previously mentioned, that if the de minimis rule does not apply, materials and supplies that improve a unit of property are capitalized whether or not the UNICAP rules require capitalization of the material or supply (Reg. §1.263(a)-3(c)(2)).

PRODUCTION OF UNIT OF PROPERTY

The de minimis rule applies to amounts paid or incurred for the production of a unit of property that fall within the $500/$5,000 per-item limitation. For example, the capitalized cost of building a computer for a taxpayer's own use is deductible under the de minimis rule if the total cost does not exceed the applicable dollar limit.

"Produce" for purposes of the de minimis rule is defined to mean construct, build, install, manufacture, develop, create, raise, or grow. Production does not include improvements to a unit of property (Reg. §1.263(a)-1(c)(2)). Production is similarly defined under the UNICAP rules but includes the direct and indirect costs of improving property. (Code Sec. 263A(g)).

PROPERTY WITH ECONOMIC USEFUL LIFE OF 12 MONTHS OR LESS

Property with an economic useful life of 12 months or less is a type of material and supply that is covered by the de minimis safe harbor if the taxpayer's book expensing policy provides for the expensing of such property (Reg. §1.263(a)-1(f)(3)(vii)).

It is not necessary for the accounting procedure to specify a cost limit on property with a short economic useful life that is expensed for financial accounting purposes. The default limit for tax purposes is considered $5,000 or $500, as applicable. However, the accounting procedure must specify a limit for other types of property.

EXAMPLE. ABC has no AFS. Its book procedure requires the expensing of tangible property costing $300 or less, and the entire cost of property with an economic useful life of less than 12 months. ABC purchases a point of service device costing $400 and a computer costing $600. Both items have an economic useful life of less than 12 months. ABC may deduct the cost of the $400 point of service device under the safe harbor because its economic useful life is 12 months or less and its cost does not exceed $500. Even though the cost of the $600 computer is expensed for book purposes because it has a short economic life, it may not be deducted under the safe harbor because its cost exceeds $500 (Reg. §1.263(a)-1(f)(7), Exs. 7 and 8).

AFS DEFINED

An "applicable financial statement" is defined as:

- A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);
- A certified audited financial statement that is accompanied by the report of an independent certified public accountant (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
- 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) (Reg. §1.263(a)-1(f)(4)).

A taxpayer may have more than one of the preceding applicable financial statements. For purposes of applying the de minimis rule, the statement in the highest category (i.e., item (1) being the highest) is treated as the AFS. This will be treated as the statement for which a written accounting procedure must be in effect (Reg. §1.263(a)-1(f)(4)).

Consolidated groups. If the taxpayer's financial results are reported on the AFS for a group of entities, then the group's AFS may be treated as the AFS of the taxpayer, and the written accounting procedures provided for the group and utilized for the group's AFS may be treated as the written accounting procedures of the taxpayer (Reg. §1.263(a)-1(f)(3)(vi)).

Elections Under Final Repair Regs

Election	Accounting Method	Due Date	Reg Section	2012/2013 Amended Return Option
Election to Capitalize Rotable, Temporary, or Standby Emergency Parts	NO	Capitalize and depreciate on timely filed original federal tax return (including extensions) for the tax year the asset is placed in service; no statement required	Reg. §1.162-3(d); Reg. §1.162-3(j)(2)	YES
Partial Disposition Election	NO*	Report gain/loss on timely filed original return (including extensions) in year of disposition; no statement required	Prop. Reg. §1.168(i)-8(d)(2)(iv)	YES
De Minimis Safe Harbor Election	NO**	Attach statement to timely filed return (including extensions) each year	Reg. §1.263(a)-1(f); Reg. §1.263(a)-1(h)(2)(ii)	YES
Election to Capitalize Employee Compensation or Overhead	NO	Treat amounts to which election applies as capitalized on timely filed original return (including extensions) for which amounts are paid or incurred; no statement required	Reg. §1.263(a)-2(f)(2)(iv)(B); Reg. §1.263(a)-2(f)(2)(ii)	YES
Election by Small Taxpayer to Deduct Building Improvements	NO	Attach statement to timely filed return (including extensions) each year	Reg. §1.263(a)-3(h); Reg. §1.263(a)-3(r)(2)(ii)	YES
Election to Capitalize Repair and Maintenance per Books	NO	Attach statement to timely filed return (including extensions) each year	Reg. §1.263(a)-3(n); Reg. §1.263(a)-3(r)(2)(ii)	YES

* Late partial disposition election for assets placed in service in tax years beginning before January 1, 2012 is an accounting method change; Accounting method change or amended return may be filed to claim a loss on certain 2012 or 2013 partial dispositions

** *De minimis* safe harbor is an accounting method change under the temporary regulations

INVOICE PRICE

The final regulations provide an anti-abuse rule that prohibits taxpayers from manipulating a transaction to avoid the $5,000 or $500 per item limit. The rule specifically prohibits "componentization" of an item of property. For

example, a taxpayer who purchases a truck cannot split the cost of the truck into three components (e.g., engine, cab, chassis) on three invoices in order to avoid the dollar limit (Reg. §1.263(a)-1(f)(6)).

A taxpayer must include in the cost of the property all additional costs, such as delivery fees, installation services, and similar costs that are included on the same invoice as the invoice for the cost of the property. If these additional costs are not included on the same invoice as the property, the taxpayer may, but is not required to, include the additional costs in the cost of the item of property (Reg. §1.263(a)-1(f)(3)(i)).

> **PLANNING TIP.** The inclusion of additional costs by the vendor in the same invoice as the property item could unnecessarily cause the cost of the property item to exceed the $5,000 or $500 limit. The taxpayer should arrange in advance for separate invoices for the property item and additional costs in such a situation. It does not appear that this strategy would violate the anti-abuse rule.

When multiple items of property are purchased and additional costs are stated as a lump sum, the taxpayer must use a reasonable method to allocate the additional costs among the items of property when computing the per-item cost.

LIMITS MAY BE SET LOWER THAN $500/$5,000 CAP

The de minimis rule can be elected even if the taxpayer's non-tax accounting procedure sets the expensing limit for non-tax purposes above or below the $5,000/$500 tax deduction limit. For example, the written accounting procedure of a taxpayer with an AFS could provide that amounts not in excess of $10,000 are deducted for financial accounting purposes. However, only items costing no more than $5,000 could be deducted for tax purposes and receive audit protection under the de minimis safe harbor.

> **EXAMPLE.** A taxpayer without an AFS has an accounting procedure in place at the beginning of the tax year to expense amounts costing $1,000 or less, and treats such amounts as current expenditures on its books and records. The taxpayer purchases a $600 computer. Although the taxpayer must expense $600 on its books, it may not deduct any portion of the $600 under the de minimis rule for tax purposes because $600 exceeds the $500 tax deduction limit. If the taxpayer deducts $600, the safe harbor does not protect any portion of that amount from IRS review. However, any items costing $500 or less and deducted for tax purposes could not be disallowed on

audit (Reg. §1.263(a)-1(f)(7), Exs. 2 and 4).

The taxpayer's accounting policy may provide different limits for different types of property.

EXAMPLE. A taxpayer without an AFS has an accounting policy under which office furniture costing less than $300, and all other items of property costing $500 or less, are expensed for book purposes. An item of furniture costing $500 may not be expensed for book purposes or tax purposes.

PLANNING TIP. One of the safe harbor requirements is that a taxpayer actually expense the item for financial or book accounting purposes. Thus, it appears that a taxpayer that makes the safe harbor election may avoid deducting an item that is otherwise required to be deducted under the safe harbor by choosing not to expense the amount for financial or book accounting purposes.

Nothing prevents a taxpayer from amending its accounting policy to change the book expensing threshold in order to adjust the tax expensing threshold. For example, a taxpayer with a $500 per-item book threshold in one year could lower it to $300 in the following year in order to limit tax deductions to items costing $300 or less. Such a change is not a change in accounting method (Preamble to T.D. 9636).

COORDINATION WITH THE UNICAP RULES

The uniform capitalization (UNICAP) rules require a taxpayer to capitalize amounts that are otherwise deductible under the de minimis safe harbor if the amounts constitute direct or allocable indirect costs of other property produced by the taxpayer (e.g., an improvement to a property) or property acquired for resale (Reg.§1.263(a)-1(f)(3)(v)).

Indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date.

EXAMPLE. ABC acquires a component part of a machine that is installed, or expected to be installed in the future, in manufacturing equipment used to produce property for sale. ABC must capitalize the cost of the component part as an indirect cost of property produced by the taxpayer, even though it is otherwise deductible under the de minimis safe harbor as a material or supply. However, if ABC

acquires the component without expecting to use it in the production of property, the cost may be expensed under the de minimis rule even if expectations change in a subsequent tax year and the property is actually used in production (Preamble to T.D. 9636).

PLANNING TIP. Amounts expensed under Code Sec. 179 are not subject to the UNICAP rules (Reg. §1.263A-1(e)(3)(iii)(C)). Accordingly, a taxpayer should consider expensing any amount that might otherwise be eligible for expensing under the de minimis rules but would still need to be capitalized under UNICAP.

MAKING THE ELECTION

Under the final regulations, the de minimis rule is a safe harbor that is elected annually by the extended due date of the original income tax return. The election is irrevocable. The election is made by a partnership or S corporation, not by the partners or shareholders (Reg. §1.263(a)-1(f)(5)).

A statement described in Reg. §1.263(a)-1(f)(5) must be attached to the return. An election statement is provided in the CCH Election and Compliance Toolkit on IntelliConnect.

A late election may be made on an amended return only with IRS consent.

If a taxpayer wanted to make the de minimis election for a tax year beginning on or after January 1, 2012, and ending on or before September 19, 2013, and the taxpayer did not make the election on its timely filed original return, the final regulations allowed a taxpayer to make the election by filing an amended return on or before 180 days from the due date, including extensions (even if no extension was requested), of the taxpayer's tax return for such tax year (Reg. §1.263(a)-1(g)(2)(ii)).

ACCOUNTING METHOD CHANGE NOT REQUIRED

The de minimis safe harbor is not an accounting method under the final regulations (Reg. §1.263(a)-1(h)(2)(ii)).

3. Unit Of Property

KEY CHANGES TO TEMPORARY REGULATIONS:

- The final regulations make no significant changes to the temporary regulations.

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 final 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 (Reg. §1.263(a)-3(e)).

> **IMPACT.** Generally, the larger the unit of property is, the more likely it is that costs will be characterized as a repair rather than a capital expenditure. Primarily, this is because the replacement of a major component or substantial structural part of a unit of property is considered an improvement. The smaller a unit of property is, the more likely that a component is major.

BUILDINGS AND BUILDING SYSTEMS

Although an entire building is technically defined as a single unit of property, the improvement rules are applied separately to each of nine enumerated building systems and to the remaining building structure. In effect, each building system is considered a separate unit of property and the remaining building structure is considered a separate unit- of property (Reg. §1.263(a)-3(e)(2)(i)).

> **COMMENT.** References in the following discussions to "building structure" mean a building excluding its building systems.

The nine building systems are:

1) Heating, ventilation, and air conditioning (HVAC) systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, and radiators);

2) 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);
3) Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from the property line to and between buildings and other permanent structures);
4) All escalators;
5) All elevators;
6) 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 firefighting equipment such as extinguishers and hoses);
7) 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, and associated wiring and conduits);
8) Gas distribution systems (including associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures); and
9) Other structural components that are specifically designated as building systems in future published guidance (Reg. §1.263(a)-3(e)(2)(ii)).

IMPACT. The proposed repair regulations issued in 2006 applied the improvement rules to a building and all of its structural components, including building systems. Some taxpayers claimed repair deductions based on this definition even though the proposed regulations were not reliance regulations. For example, a taxpayer may have claimed a repair expense for the cost of replacing a building's entire heating and cooling system on the grounds that the system was not a major component of the entire building. This result is clearly contrary to the final (and temporary) regulations, since the improvement rules must be applied separately to a building's heating and cooling system. Taxpayers who claimed repair deductions by applying the unit-of-property rules in the proposed regulations will need to file a change of accounting method to capitalize the amounts previously deducted if they are required to be capitalized under the unit-of-property standards in the final regulations. These taxpayers must also file a concurrent accounting

method change under Rev. Proc. 2014-16 to redefine the unit of property (Change 184).

Change 184 covers both a change in definition of a unit of property and a change from claiming a repair expense to capitalizing (or vice versa),

CAUTION! A taxpayer is required to file an accounting method change to capitalize any amount that was claimed as a repair expense in a prior tax year if that amount must be capitalized under the final repair regulations. This rule is not simply limited to taxpayers that relied on the proposed regulations to define an entire building, including its building systems, as a single unit of property. It applies to expenditures with respect to any building (whether or not the taxpayer relied on the proposed regulations) and all other types of property. A change in accounting method is also required if a taxpayer previously capitalized amounts that must be claimed as a repair expense under the final regulations (Change 184).

LEASED BUILDINGS

In the case of a lessee who leases an entire building, the unit of property is the entire building and the improvement rules are applied to the building structure and each building system in the same manner as if the lessee owned the building (Reg. §1.263(a)-3(e)(2)(v)).

The unit of property for a taxpayer that leases a portion of a building is the entire leased portion. The improvement rules are applied separately to the portion of the building structure and each building system associated to the lease (Reg. §1.263(a)-3(e)(2)(v)).

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 building's owner-lessor (or a lessee who rented the entire building) performed the same work, it might be considered a repair because the work affected only a small amount of the building's entire plumbing system.

COMMENT. If a lessee leases two office spaces in the same building under separate leases, each office is considered a separate unit of property (Reg. §1.263(a)-3(e)(6), Ex. 13).

CONDOMINIUMS AND COOPERATIVES

For a taxpayer who owns an individual unit in a condominium building, the unit of property is the entire individual unit. The improvement rules are applied separately to the building structure that comprises the individual unit and to each building system that is part of the condominium unit (Reg. §1.263(a)-3(e)(2)(iii)).

In the case of a condominium management association, the association must apply the improvement rules separately to the building structure and each building system in a manner similar to owners.

For a cooperative housing association, the unit of property is the entire portion of the building in which the taxpayer has a possessory interest. The improvement rules are applied separately to the building structure in which the possessory interest is held and to each building system in that portion of the building (Reg. §1.263(a)-3(e)(2)(iv)).

In the case of a cooperative housing corporation, the corporation must apply the improvement rules separately to the building structure and to each building system, as in the case of other building owners.

PERSONAL AND OTHER REAL PROPERTY

In the case of personal or real 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. The improvement rules are applied at the unit of property level (Reg. §1.263(a)-3(e)(3)(i)).

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

IMPROVEMENTS TO UNIT OF PROPERTY

An improvement to a unit of property is not ordinarily considered a separate unit of property (Reg. §1.263(a)-3(e)(4)). For example, an addition to a building or a new roof is not a separate unit of property even though it is depreciated beginning in the year it is placed in service as a separate asset.

The unit of property is the entire building, including the addition, provided (Reg. §1.263(a)-3(e)(4) and (6), Ex. 15).

COMPONENTS WITH DIFFERENT PROPERTY CLASSES

A component of a unit of property is treated as a separate unit of property if the component has a different property class (determined generally under Rev. Proc. 87-56) than the unit of property of which it is a part in the year that unit of property is placed in service (Reg. §1.263(a)-3(e)(5)(i)). For example, tires used on transport industry trucks are often depreciated as a separate asset over five years rather than over the three-year period that applies to the remaining portion of the truck. The tires fall within a separate property class and, therefore, are a separate unit of property in the year the truck is placed in service (Reg. §1.263(a)-3(e)(6), Ex. 16).

COMMENT. Assets with different property classes may have the same depreciation period under MACRS. Thus, in the preceding example, the tires would still be considered a separate unit of property if the assigned recovery period for their asset class was five years instead of three years.

A similar rule applies where the class life of a portion of a building or other unit of property changes after the unit of property is placed in service. For example, where a cost segregation study is performed after the building is placed in service, components reclassified as personal property are placed in a different property class (with a shorter recovery period) and, therefore, are a separate unit of property (Reg. §1.263(a)-3(e)(5); Reg. §1.263(a)-3(e)(6), Ex. 18). Also, where improvements to a building are reclassified as 15-year restaurant, leasehold, or retail improvement property in a tax year after being placed in service, the improvements are treated as separate units of property (Reg. §1.263(a)-3(e)(6), Ex. 17).

Compliance Note. Each component that is reclassified as personal property in a cost segregation study is treated as an individual unit of property. See, for example, Reg. §1.263(a)-3(j)(3), Example 5, in which each window treatment, each item of furniture, and each cabinet replaced in a major renovation is a separate unit of property.

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 (Reg. §1.263(a)-3(e)(3)(ii)).

Typically, this means that each individual 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, and 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. The functional interdependence standard is not determinative (Reg. §1.263(a)-3(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 (I.R.B. 2011-37, 326), which provides a safe harbor method for electric utility transmission and distribution property; Rev. Procs. 2011-27 (I.R.B. 2011-18, 740) and 2011-28 (I.R.B. 2011-18, 743), 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 (2001-2 CB 263) and 2002-65 (2002-2 CB 700), which provide a track maintenance allowance method for Class I railroads and for Class II and III railroads, respectively.

ACCOUNTING METHOD CHANGE

A taxpayer using a unit-of-property definition that differs from the definition in the final regulation is using an improper accounting method and is required to file Form 3115 (Reg. §1.263(a)-3(q)). See change 184 of Rev. Proc. 2014-16.

4. Amounts Paid to Improve Tangible Property

KEY CHANGES TO TEMPORARY REGULATIONS:

- The final regulations reorganize and clarify the types of activities that constitute betterments.
- Refresh examples are modified to better illustrate definition of an improvement.
- Compromise solution provided for casualty loss/repair deduction controversy.

The heart of the "repair regulations" — Reg. §1.263(a)-3 — provides rules for distinguishing between expenditures that are repairs and expenditures that are capital improvements.

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.

Facts and circumstances will continue to play an important role in distinguishing repairs from improvements. However, some important safe harbors are included.

BETTERMENTS, RESTORATIONS, AND ADAPTATIONS ARE CAPITALIZED

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

A unit of property is improved if amounts paid for activities performed after the unit of property is placed in service by the taxpayer result 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 (Reg. §1.263(a)-3(d)).

Although a building, including all of its structural components, is considered a unit of property, the improvement rules are applied separately to each of nine enumerated building systems and to the remaining building structure. In effect, each system and the remaining building structure is treated as a separate unit of property. For property other than a building, 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 (Reg. §1.263(a)-3(e)).

> **IMPACT.** 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 improvement rules are applied separately to the HVAC system, as is actually the case under the regulations, then that work will probably need to be capitalized.

The unit of property concept is discussed earlier in this e-book. References to "building structure" are to the building structure other than the building systems.

Capitalized costs. A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs that directly benefit or are incurred by reason of an improvement. For example, a repair or other expense that directly benefits an improvement or is incurred by reason of an improvement must also be capitalized (Reg. §1.263(a)-3(g)(i)).

> **EXAMPLE.** A taxpayer replaces the cab of a tractor trailer and paints its logo on the new cab. Assume the cost of replacing the cab must be capitalized. Since the painting expense was a direct result of replacing the cab, its cost is capitalized. However, the cost of replacing a tail light at the same time remains a repair expense since it was not incurred by reason of the improvement (Reg. §1.263(a)-3(k)(7), Ex.. 10, 11).

The regulations provide an exception that allows an individual to capitalize amounts paid for repairs and maintenance that are performed at the same time as capital improvements to a residence (e.g., a remodeling project) or other unit of property that is not used in a trade or business (Reg. §1.263(a)-3(g)(1)(ii)).

REMOVAL EXPENSES

The final regulations clarify the treatment of removal costs of assets and components of assets. No change is made to the current rule allowing the deduction of removal costs when an asset is retired or removed in connection with the replacement of the asset (Rev. Rul. 2000-7, 2000-1 CB 712; Preamble to T.D. 9636).

The regulations provide that if a taxpayer disposes of a depreciable asset or a component of an asset and takes the adjusted basis of the asset or the component into account in realizing gain or loss, then the costs of removing the asset or component are not capitalized. If a taxpayer disposes of a component of a unit of property, but the disposal of the component is not a disposition (e.g., because no partial disposition election was made to claim a retirement loss), then the taxpayer must capitalize the removal costs if the costs directly benefit or are incurred by reason of an improvement to the unit of property (Reg. §1.263(a)-3(g)(2)). For example, the cost of removing shingles on a roof is deductible if the replacement costs are a deductible repair and no loss is claimed on the replaced shingles. However, if the entire roof is replaced and the replacement costs are capitalized, the removal costs must also be capitalized provided no loss is claimed on the replaced roof, for example, by making a partial disposition election under Reg. §1.168(i)-8(d))

CAUTION. The cost of demolishing a building is capitalized (Code Sec. 280B) (unless, as explained later in this report, the building was placed in a GAA). Demolition costs of property other than a building are capitalized if the taxpayer acquired the property with an intent to demolish (Reg. §1.165-3). In the case of a building, other than a certified historic structure, a modification of a building is not a demolition if (1) 75 percent or more of the existing external walls of the building are retained in place as internal or external walls, and (2) 75 percent or more of the existing internal structural framework of the building is retained in place (Rev. Rul. 95-27, 1995-1 CB 704).

Accounting method change for removal costs. Appendix Section 10.03(1) of Rev. Proc. 2011-14 currently provides an automatic method change procedure for changing to the method described in Rev. Rul. 2000-7 for removal costs when an entire asset is retired or removed. Section 3.01(4) of Rev. Proc. 2014-16 extends this automatic change to removal costs paid or incurred in the disposal of a depreciable asset, including a partial disposition (Change 21). If a disposal of a component of an asset is not a disposition for

federal income tax purposes, a change of accounting with respect to removal costs to comply with the final regulations is made under the automatic consent procedures of Appendix Sec. 10.11 of Rev. Proc. 2011-14 as modified by Rev. Proc. 2014-16 (Change 184).

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 (or arose during the production of the property), whether or not the taxpayer was aware of the condition or defect at the time of acquisition;
- Is for a material addition to the unit of property, such as a physical enlargement, expansion, extension, or addition of a new major component;
- Is for a material increase in the capacity of the unit of property, such as additional cubic or linear space; or
- Is reasonably expected to materially increase the productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property (Reg. §1.263(a)-3(j)(1)).

COMPLIANCE NOTE. The temporary regulations provided that the expenditure must "result in" a material increase in the productivity, efficiency, strength, etc., of the unit of property. The final regulations substitute a "reasonable expectation" standard to reduce controversy. Consequently, if the result is different than the taxpayer's reasonable expectation, a taxpayer does not change the erroneous repair or capitalization treatment on an amended return or by filing a change in accounting method. This change will reduce controversy for expenditures that span more than one tax year or when the outcome of the expenditure is uncertain when the expenditure is made (Preamble to T.D. 9636).

COMMENT. Although the purpose of the expenditure, the physical nature of the work performed, and the effect of the expenditure on the unit of property are all relevant in determining whether an expenditure results in a betterment, the IRS removed the taxpayer's treatment of the expenditures on an applicable financial statement (AFS) as a relevant factor because taxpayers do not necessarily apply federal tax standards to an AFS.

The final regulations include 23 separate examples illustrating the betterment rules. Some of the examples are categorized and summarized below.

Amelioration of pre-existing conditions. The amelioration of a material defect or condition that existed prior to the taxpayer's acquisition of the property is a betterment.

- Cost of remediating soil contaminated by prior owner's leaking underground tank ameliorates a material condition or defect that existed prior to taxpayer's acquisition of the land and must be capitalized as a betterment (Reg. §1.263(a)-3(j)(3), Ex. 1).
- Removal costs of asbestos that began to deteriorate after the purchase of a building do not result in a betterment (Reg. §1.263(a)-3(j)(3), Ex. 2).
- Costs to perform scheduled standard maintenance on a used machine shortly after its purchase or to perform a tune-up on a used ice resurfacing machine immediately after purchase do not ameliorate a preexisting material condition or defect and are not betterments (Reg. §1.263(a)-3(j)(3), Exs. 3 and 4).
- Taxpayer who acquired assisted living building in disrepair must capitalize cost of fixing damaged drywall, repainting, re-wallpapering, replacing windows, repairing and replacing doors, replacing and regrouting tile, repairing millwork, and repairing and replacing roofing materials, as well as the cost of replacing each item of section 1245 property treated as a separate unit of property, including window treatments, furniture, and cabinets (Reg. §1.263(a)-3(j)(3), Ex. 5).

Building Refreshes. The final regulations revise three retail building refresh examples to provide a clearer delineation between "refresh" costs that are deductible and those that must be capitalized. The examples illustrate distinctions between betterments and maintenance activities when a taxpayer undertakes multiple simultaneous activities for a building. Each example assumes that the refreshes did not ameliorate pre-existing conditions. In each example, the cost of each item of section 1245 property that is a separate unit of property is capitalized.

- *Cosmetic and layout changes and general repairs and maintenance.* Replacing and reconfiguring display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing wood flooring throughout the store

building, and power washing building exteriors are currently deductible as costs that keep the building structure and systems in their ordinarily efficient operating condition (Reg. §1.263(a)-3(j)(3), Ex. 6).

- *Building refresh with limited improvements.* Amounts paid in addition to those above to add a loading dock and second hanging door to the building and substantially upgrade the electrical system are unrelated to the building refresh and must be capitalized as betterments (Reg. §1.263(a)-3(j)(3), Ex. 7).
- *Capitalized building remodel.* Cost of replacing large parts of the exterior walls with windows, replacing the escalators with a monumental staircase, adding a new glass enclosed elevator, rebuilding the interior and exterior facades, replacing vinyl floors with ceramic flooring, replacing ceiling tiles with acoustical tiles, removing and rebuilding walls to move changing rooms and create specialty departments, and upgrading the capacity of the electrical system is a major remodel and the costs must be capitalized. In addition, amounts paid to clean debris resulting from construction during the remodel, patch holes in walls that were made to upgrade the electrical system, repaint existing walls with a new color scheme to match the new interior construction, and to power wash building exteriors to enhance the new exterior façade are capitalized because they were a direct consequence of the capitalized remodeling activities (Reg. §1.263(a)-3(j)(3), Ex. 8).

CAUTION! As noted above, otherwise deductible repair costs that directly benefit or are incurred by reason of an improvement must be capitalized (Reg. §1.263(a)-3(g)).

The fact that a taxpayer incurs costs on account of a regulatory requirement is not relevant in determining whether the costs result in a capitalizable improvement (Reg. §1.263(a)-3(g)(4)). Thus, the cost of adding expansion bolts that materially increase the strength of a building structure to protect against earthquakes as required by city ordinance is a capitalized betterment (Reg. §1.263(a)-3(j)(3), Ex. 11). However, the cost of sealing a concrete wall and floor with additional concrete to stop oil seepage that began after the taxpayer purchased the plant is not a betterment. The costs restored the building structure to its condition when purchased by the taxpayer without materially adding to its efficiency, strength, quality, etc. (Reg. §1.263(a)-3(j)(3), Ex. 12).

COMMENT. If the seepage had occurred prior to the taxpayer's purchase, then the fix-up costs would likely be considered a betterment that ameliorates a material defect that existed prior to acquisition of the property unit.

Compared to prior condition of property. In determining whether a taxpayer's expenditures result in a betterment, the condition of the property after the expenditures is compared to the condition of the property at a particular point of time prior to the expenditures.

If the expenditure is made to correct normal wear and tear that occurred to the unit of property after the taxpayer acquired it, the comparison is made to the condition of the property after the taxpayer last corrected the effects of normal wear and tear; or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer (Reg. §1.263(a)-3(j)(2)(iv)(B)).

EXAMPLE. A taxpayer acquires a building with a good roof. Over time the roof becomes leaky and the taxpayer replaces the roof membrane. The replacement costs are not a betterment because the taxpayer is merely restoring the roof to its condition when the taxpayer placed it in service (Reg. §1.263(a)-3(j)(3), Ex. 13).

CAUTION! Although the replacement is not a betterment, it is still necessary to consider whether the expenditures resulted in a restoration under the improvement rules. For example, if an entire roof falls into disrepair while a taxpayer owns it, the replacement is not a betterment; however, it would be characterized as a capitalizable restoration because a major component of a unit of property was replaced, as explained below.

EXAMPLE. Where a harbor channel was 10 feet deep when it was purchased, the cost to increase it to 20 feet is a betterment because it results in a material increase in capacity. If siltation of the 20 foot channel later reduces its depth to 10 feet, the cost of redredging is not a betterment because the channel is merely being restored to its condition at the time of the taxpayer's most recent "repair". If siltation once again reduces the channel depth to 10 feet but the channel is redredged to a depth of 25 feet, the redredging results in a material increase in the channel's capacity compared to the time of the most recent repair (i.e., from 20 feet to 25 feet) and the entire redredging cost is capitalized as a betterment. The portion of the cost of redredging from the 10- to 20-foot depth, although technically a repair expense, must be capitalized because that portion of the dredging directly benefits and is incurred by reason of increasing the capacity of the channel an additional five feet to 25 feet (Reg. §1.263(a)-3(j)(3), Exs. 14, 15 and 16).

There are no bright-line percentage tests for determining what constitutes a material increase in capacity, efficiency, etc. However, the channel example demonstrates that a 25-percent increase (from 20 to 25) would generally be considered by the IRS as a material increase. In other examples, new insulation that increases a building's energy efficiency by 50 percent and the reinforcement of building columns to increase the load-bearing capacity by 50 percent are betterments (Reg. §1.263(a)-3(j)(3), Exs. 21 and 14). A final example concludes that replacing two of ten HVAC units with new units that are ten percent more efficient does not result in a betterment. However, because the ten units are a building system that is treated as a single unit of property, the overall increase in efficiency to the single unit of property is far less than 10 percent (Reg. §1.263(a)-3(j)(3), Ex. 20).

Where the property is damaged during the taxpayer's use (e.g., a casualty event), the determination of whether the expenditure results in a betterment is made by comparing the condition of the property immediately prior to the damage with the condition of the property immediately after the expenditure (Reg. §1.263(a)-3(j)(2)(iv)(C)).

COMMENT. As long as the damaged property is returned to its original condition, there is no betterment. However, as explained below, the restoration rules will usually require the capitalization of the costs of restoring property damaged in a casualty.

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) (Reg. §1.263(a)-3(j)(2)(iii)).

The final regulations no longer provide a specific example of the application of this principle. The following examples from the temporary regulations were removed without explanation but continue to illustrate the general principle.

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, do not absorb moisture and have a 50-year warranty and a Class A fire rating is a betterment (Temp. Reg. §1.263T(a)-3 (j)(4), Exs. 14 and 15).

RESTORATIONS ARE CAPITALIZED IMPROVEMENTS

Restorations are the second category of capitalized improvements. An amount is paid to restore a unit of property if:

- The taxpayer replaces a component of a unit of property and deducts a loss for that component (other than a casualty loss);
- The taxpayer replaces a component of a unit of property and realizes gain or loss by selling or exchanging the component;
- The expenditure is for the restoration of damage to a unit of property caused by a casualty and the taxpayer is required to make a basis adjustment to the unit of property on account of a casualty loss or the receipt of insurance (a limited exception is discussed below);
- The expenditures return 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 (i.e., MACRS ADS recovery period); 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 (Reg. §1.263(a)-3(k)(1)).

CAUTION! Although the definition of materials and supplies includes "components acquired to maintain, repair, or improve a unit of tangible property," the rule that allows the cost of 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 (Reg. §1.263(a)-3(c)(2)). 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 that is a material or supply if the material or supply replaces a component for which a retirement loss deduction is claimed, because the cost of the replacement is considered a restoration when a loss deduction is claimed. As previously discussed, however, the de minimis safe harbor election may apply to allow a material or supply that improves a unit property to be currently deducted, assuming the UNICAP rules do not apply to the expenditure.

Loss deductions on replaced components preclude repair deductions. 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 (Reg. §1.263(a)-3(k)(1)(i)).

EXAMPLE. Purchasing and installing minor components of a freezer (a unit of property) is capitalized as a restoration if an abandonment loss deduction is claimed on the replaced components or the replaced components are sold for a gain or loss (Reg. §1.263(a)-3(k)(7), Exs. 1 and 2).

This rule, however, does not apply if a loss deduction or the gain or loss realized on a sale or exchange is attributable only to the remaining salvage value on a fully depreciated unit of property (Reg. §1.263(a)-3(k)(3)).

COMMENT. Prior to ACRS and MACRS (basically before 1981), an asset could not usually be depreciated below salvage value. The salvage value of such assets (if already disposed of) should have been taken into account when the asset was sold or abandoned for purposes of computing gain or loss. This means, for example, that a taxpayer who scrapped a fully depreciated pre-ACRS asset without taking a loss for salvage value may not now claim a loss deduction unless the statute of limitations for amending the return in the year of loss has not expired.

In general, the retirement of a component will generate a loss (equal to the adjusted depreciable basis of a component; that is, cost less depreciation previously claimed) only if the component is part of an "asset" and the taxpayer makes a partial disposition election described below (Reg. §1.168(i)-8(d)(2)).

In the case of a building, the entire building, including its structural components, is treated as an asset (Reg. §1.168(i)-8(c)(4)). Thus, a taxpayer can elect to claim a loss upon the retirement of any portion of the building. However, the election should not be made if it would prevent the taxpayer from claiming a repair deduction.

EXAMPLE. ABC replaces the membrane on a roof. If ABC makes the partial disposition election and claims a loss equal to the undepreciated basis of the membrane, ABC may not claim a repair deduction. ABC, therefore, should not make the election. However, if ABC replaces the entire roof, the replacement cost must be capitalized as a restoration because the entire roof is a substantial structural part of the building structure (excluding the nine enumerated building systems). In this situation ABC should make the partial disposition election.

COMMENT. Although the entire building is a unit of property, the final regulations provide that the improvement rules are applied separately to the building structure and separately to each of the nine enumerated building systems. Thus, the replacement of a part or combination of parts that constitute a major component or a substantial structural part of the building structure or one of the building systems results in a restoration that is an improvement. In the example above, the entire roof is a substantial structural part of the building structure. Therefore, its replacement cost is capitalized as a restoration.

Casualty losses. The IRS ruffled a few feathers by taking the position in the temporary regulations that no portion of an amount claimed as a casualty loss is a deductible repair expense if the basis of a property is reduced on account of a casualty loss (Temp. Reg. §1.263(a)-3T(i)). The rule would have applied even if the amount of the casualty loss relative to the restoration costs was insignificant. This situation often occurs because casualty loss deductions are generally limited to the lesser of the decline in fair market value of the damaged property or its remaining depreciable basis (Reg. §1.165-7(b)).

Taxpayers argued that all restoration expenditures paid or incurred on account of a casualty should be deductible. Restoration costs refers to expenses that are improvements and expenses that are repairs, such as clean-up costs.

The final regulations compromise somewhat by allowing a taxpayer to claim a repair deduction if the restoration expenditures exceed the adjusted basis of the property prior to reduction by the casualty loss or insurance reimbursement (Reg. §1.263(a)-3(k)(4)(i)).

COMMENT. A taxpayer may receive insurance and not be able to claim a casualty loss. Nevertheless, the receipt results in a basis adjustment and is a casualty "event" that triggers this rule.

EXAMPLE. A storm damages a building with an adjusted basis of $500,000. The cost of restoring the building is $750,000, consisting of a roof replacement ($350,000) and clean-up/repair costs ($400,000). A $500,000 casualty loss is claimed. The cost of the roof must be capitalized as a restoration/improvement because it is a major component and substantial structural part of the building structure. The remaining $400,000 clean-up/repair costs must be capitalized to the extent of the $150,000 excess of the building's adjusted basis ($500,000) over the capitalized cost of the roof ($350,000). The excess $250,000 of repair/clean-up costs ($400,000 – $150,000) may be currently deducted (Reg. §1.263(a)-3(k)(7), Exs. 3, 4, 5).

COMMENT. A taxpayer is not required to claim a casualty loss; however, the basis of the damaged property must still be reduced by the amount of the casualty loss that could have been claimed. Consequently, not claiming a casualty loss deduction would not change the results in the preceding examples (Preamble to T.D. 9636, citing Code Sec. 1016(a)).

Replacement of major component or substantial structural part. The cost of replacing a part or combination of parts that comprise a major component or a substantial structural part of a unit of property is a capitalized restoration (Reg. §1.263(a)-3(k)(1)(vi)). In the case of a building, this test is applied separately to the building structure and each building system (Reg. §1.263(a)-3(k)(2)).

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, are taken into account in determining whether a major component or substantial structural part of a unit of property has been replaced (Reg. §1.263(a)-3(k)(6)(i)).

COMMENT. This facts-and-circumstances standard replaces the generous bright-line 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.

The final regulations now provide a definition of a major component as a part or combination of parts that performs a discrete and critical function in the operation of the unit of property. An “incidental component” is not a major component even if it performs a discrete and critical function (Reg. §1.263(a)-3(k)(6)(i)(A)).

A substantial structural part of a unit of property or building is a combination of parts that comprise a large portion of the physical structure of the unit of property or building (Reg. §1.263(a)-3(k)(6)(i)(B) and (ii)(B)).

EXAMPLE. A new engine installed on the tractor (a unit of property) of a petroleum hauling truck is a major component but not a substantial structural part of the truck. A new cab is a major structural component and a substantial structural part of the truck. A new petroleum tank installed on the trailer (a separate unit of property) is both a major component and a substantial structural part of the trailer. Replacement costs are capitalized (Reg. §1.263(a)-3(k)(7), Ex. 10).

The replacement of a significant portion of a major component of the building structure or a building system is treated as a restoration (Reg. §1.263(a)-3(k)(6)(ii)(A)). The significant-portion standard only applies to buildings.

EXAMPLE. A building has 300 exterior windows. The 300 windows constitute a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. The cost of replacing 100 of the 300 windows is not a capitalizable restoration because the 100 windows are not a significant portion of the major component. If 200 windows are replaced, however, a significant portion of a major component is replaced and the replacement costs must be capitalized (Reg. §1.263(a)-3(k)(7), Exs. 25 and 26).

COMMENT. According to other examples, 300 windows are not a substantial structural part of the building structure where they comprise 25 percent of the exterior surface area. However, 300 windows that comprise 90 percent of the total surface area the building constitute a substantial structural part of the building structure, and the replacement of 100 of those windows is a capitalizable restoration (Reg. §1.263(a)-3(k)(7), Ex. 27).

Restoration of deteriorated units of property. A taxpayer who allows a unit of property to deteriorate to a point where it is no longer fit for its intended use must capitalize the costs of returning the property to its ordinarily efficient operating condition (Reg. §1.263(a)-3(k)(1)(iv)).

EXAMPLE. Amounts paid to shore up the walls and replace the siding of an outbuilding on a farm are restoration expenses where the building was in such a state of disrepair that it was no longer structurally sound and functional for its intended use (Reg. §1.263(a)-3(k)(7), Ex. 6).

COMPLIANCE NOTE. 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 usually be capitalized as a restoration.

Rebuilds to like-new condition. A rebuild to a like-new condition after the end of a unit of property's class life is a capitalizable restoration. A unit of property is rebuilt to a like-new condition if the costs bring the property to the manufacturer's original specifications or a similar status under the terms of applicable federal guidelines. A comprehensive maintenance program, such as a government-mandated continuous maintenance program for commercial airplanes, does not return a property to a like-new condition (Reg. §1.263(a)-3(k)(5)).

EXAMPLE. After the end of the class life (i.e., ADS recovery period) of a railroad freight car, a rebuild is performed to bring the car to the manufacturer's original specifications. The rebuild includes complete disassembly, substantial upgrades of various components, replacement of various components, and refurbishing of other components (e.g., sandblasting and repainting). Because the rebuild took place after the end of the car's class life, all rebuild costs are capitalized. However if the rebuild took place prior to the end of the class life, the costs should be reviewed under the other capitalization rules for restorations and betterments. For example, the upgrading costs are capitalized as betterments and the costs of replacing the major components are capitalized as a restoration. Sandblasting and repainting costs may be deductible as repairs if they do not directly benefit the improvements and are not incurred by reason the improvements (Reg. §1.263(a)-3(k)(7), Exs. 7 and 8).

ADAPTATIONS ARE CAPITALIZED IMPROVEMENTS

An adaptation to a new or different use is a type of improvement that is capitalized (Reg. §1.263(a)-3(l)). 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 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 (Reg. §1.263(a)-3(l)(3), Ex. 4).

ACCOUNTING METHOD CHANGES

Taxpayers who previously deducted expenses that should have been capitalized under the rules for betterments, restorations, and adaptations are required to change their accounting method and compute a positive (unfavorable) Code Sec. 481(a) adjustment equal to the difference between the deducted amount and the amount of any depreciation that could have been claimed on the capitalized amount prior to the year of change. Changes include a change to capitalize and, if applicable, a change to depreciate the capitalized amount. A change in the definition of a unit of property may also be required. Change 184 of Rev. Proc. 2014-16 applies to these three changes in accounting method under the final regulations.

Change 184 also applies where a taxpayer capitalized amounts that should have been deducted under the standards of the final regulations. In this situation, the taxpayer computes a negative (favorable) Code Sec. 481(a) adjustment equal to the difference between the capitalized amount and any depreciation claimed on the capitalized amount prior to the year of change.

5. Routine Maintenance Safe Harbor

KEY CHANGES TO TEMPORARY REGULATIONS:

- The routine maintenance safe harbor is expanded to include buildings.
- Network assets are excluded from the safe harbor.

IN GENERAL

The costs of performing certain routine maintenance activities on a unit of property, including a building structure or one of the enumerated building systems, are currently deductible under a routine maintenance safe harbor (Reg. §1.263(a)-3(i)).

This safe harbor is not elective.

Under the safe harbor, an amount paid is deductible if it is for ongoing activities that, as a result of the taxpayer's use of the unit of property, the taxpayer expects to perform to keep the unit of property in its ordinarily efficient operating condition. In the case of a building, the building structure and each building system is treated as a separate unit of property (Reg. §1.263(a)-3(i)(1)(i) and (ii)).

> **CAUTION!** The maintenance must be attributable to the taxpayer's use of the property. Thus, the safe harbor does not apply to scheduled maintenance performed shortly after purchasing a used machine or an existing building.

The activities are routine only if, at the time the unit of property is placed in service by the taxpayer, 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)). However, in the case of a building structure or building system, the taxpayer must expect to perform the activities more than once during the ten-year period beginning when the building structure or building system is placed in service by the taxpayer (Reg. §1.263(a)-3(i)(1)(i) and (ii)).

COMMENT. The inclusion of a routine maintenance safe harbor for buildings is expected to alleviate some of the difficulties that could arise in applying the improvement standards for certain restorations to building structures and building systems.

The 10-year period may be rather limited for many maintenance items, especially in connection with "smart" buildings and other "low- or no-maintenance" structures. Once again, this is a safe harbor under which maintenance at longer intervals might not be required to be capitalized depending upon the facts and circumstances. The IRS further assured companies that it would not apply hindsight in determining whether the taxpayer properly anticipated maintenance more than once over a 10-year period. Thus, so long as the taxpayer reasonably expected to perform the maintenance at least twice in the ten-year period, the safe harbor applies even if the maintenance occurred only once.

PLANNING TIP. The safe harbor continues to apply after the end of the asset's class life or building's the 10-year period. For example, if routine maintenance is performed on a machine twice during its five-year ADS recovery period, routine maintenance performed in the seventh year, ninth year, and beyond also qualifies.

Rotable and temporary spare parts are not covered by the safe harbor if the taxpayer uses the optional method of accounting (Reg. §1.162-3(e)) for these parts (Reg. §1.263(a)-3(i)(3)(viii)).

Examples of routine maintenance activities include the inspection, cleaning, and testing of the unit of property, and the replacement of damaged and worn parts with comparable and commercially available and reasonable replacement parts (Reg. §1.263(a)-3(i)(1)(i) and (ii)).

Factors considered in determining whether a taxpayer is performing routine maintenance and whether the taxpayer's expectation of performing the maintenance more than once during the asset's class life (or the ten-year period for a building structure or system) is reasonable include the recurring nature of the activity; industry practice; manufacturers' recommendations; and the taxpayer's experience (Reg. §1.263(a)-3(i)(1)(i) and (ii)).

COMMENT. The final regulations remove the taxpayer's treatment of the activity on its applicable financial statement as a factor.

EXAMPLE. Aircraft engine shop visits performed every four years under a continuous maintenance program required by the government qualify for the safe harbor. In a shop visit, an engine is completely

disassembled and the parts are inspected and cleaned or replaced with comparable parts. The engine is then reassembled and tested. The safe harbor applies whether or not the engine is a rotable spare part (provided the optional accounting method is not used) and applies to maintenance performed after the end of the class life (Reg. §1.263(a)-3(i)(6), Exs. 1, 2 and 3).

EXAMPLE. Routine maintenance performed on a tugboat engine every four years (tugboat has class life of 18 years) qualifies for the safe harbor. However, if performance upgrades are made to the engine as part of the maintenance, all of the maintenance costs must be capitalized as a betterment because the maintenance directly benefits the upgrades (Reg. §1.263(a)-3(i)(6), Exs. 10 and 11).

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 of the replaced component, a basis adjustment is required on account of a casualty loss or event, or deteriorated and nonfunctional property is restored to its ordinarily efficient operating condition (Reg. §1.263(a)-3(i)(3)).

IMPACT. Betterments and adaptations to a unit of property do not qualify for the safe harbor (Reg. §1.263(a)-3(i)(3)). However, restorations, other than bringing deteriorated and nonfunctional property back to an operating condition and claiming gain or loss on a replacement component, are not excluded. Thus, the replacement of a major component or substantial structural part of a unit of property, which is normally capitalized as a restoration, can qualify for the safe harbor provided that the unit of property has not deteriorated to an unusable condition, the replacement occurs as part of routine maintenance, and the routine maintenance is expected to occur at least twice during the unit's class life (or a ten-year period in the case of a building structure or system).

EXAMPLE. The replacement every three years of the lining of a container (a unit of property with a 12-year class life) in which raw materials are placed as part of a production process qualifies for the safe harbor if no loss is claimed on the remaining basis of the lining even though the lining is a substantial structural part of the container as it comprises 60 percent of its total physical structure. However, its replacement cost may need to be capitalized under Code Sec. 263A as a direct or allocable indirect cost of producing property (Reg. §1.263(a)-3(i)(6), Ex. 6).

The final regulations provide only two examples to illustrate the routine maintenance safe harbor method for buildings.

EXAMPLE. Replacement of escalator handrails every four years is covered by the routine maintenance safe harbor since the replacement will occur twice during the applicable ten-year period. However, replacement of the escalator stairs every 15 years does not qualify. The replacement costs of the stairs are capitalized as a restoration since they comprise a major component of the unit of property (i.e., the escalators, which are a building system) and are not replaced as part of routine maintenance performed at least twice during a ten-year period (Reg. §1.263(a)-3(i)(6), Exs. 13 and 14).

EXAMPLE. Maintenance expected to be performed every four years on a building's HVAC system qualifies for the safe harbor. The maintenance includes disassembly, cleaning, inspection, repair, replacement of parts with comparable parts as necessary, reassembly and testing. If the second maintenance is performed after expiration of the applicable ten-year period, it may qualify under the safe harbor provided it was reasonably expected to be performed four years after the first maintenance (Reg. §1.263(a)-3(i)(6), Ex. 15).

NETWORK ASSETS

The final regulations provide that the routine maintenance safe harbor does not apply to network assets (as defined above in the discussion of Units of Property) (Reg. §1.263(a)-3(i)(3)(vii)). This exception was added because of the difficulty in defining the unit of property for network assets and the preference for resolving issues involving them through the Industry Issue Resolution (IIR) program (Preamble to T.D. 9636).

COORDINATION WITH UNICAP

Amounts paid for routine maintenance may be subject to capitalization under the uniform capitalization (UNICAP) rules of Code 263A if these amounts comprise the direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale (Reg. §1.263(a)-3(i)(5)). For example, under UNICAP, the cost of repairing equipment or facilities allocable to property produced or property acquired for resale is capitalized.

ACCOUNTING METHOD CHANGES

The routine maintenance safe harbor is considered an accounting method and requires a full Code Sec. 481(a) adjustment (i.e., it is not a "paid or incurred" method applied on a cut-off basis) (Reg. §1.263(a)-3(q)).

To change to the safe harbor method provided in the final regulations under Rev. Proc. 2014-16, a taxpayer files Form 3115 using change 184.

COMMENT. Rev. Proc. 2012-19 assigned a specific change of accounting method number for the routine maintenance safe harbor (change 171). Rev. Proc. 2014-16 consolidates this change with other changes provided in Reg. §1.263(a)-3 (Change 184).

6. Election To Capitalize In Accordance With Books

KEY CHANGES TO TEMPORARY REGULATIONS:

- A new safe harbor allows a taxpayer to conform its tax capitalization policy with its book capitalization policy.

GENERAL RULES

Rather than going through a potentially complicated analysis to determine whether a trade or business expenditure is a currently deductible repair or a capitalized improvement, the final repair regulations allow a taxpayer to make an annual election to capitalize and depreciate as a separate asset any expenditure for repair and maintenance if the taxpayer capitalizes the expenditure on the books and records it regularly uses to compute its trade or business income.

The election applies to all amounts paid for repair and maintenance of tangible property that are treated as capital expenditures on the taxpayer's books and records for the tax year that is covered by the election. These amounts are not treated as amounts paid for repair or maintenance and, thus, are not currently deductible (Reg. §1.263(a)-3(n)(1)).

PLANNING TIP. In effect, the election is a safe harbor because the IRS cannot challenge an electing taxpayer's characterization of a repair expense as a capital expenditure. However, a taxpayer that does not make this election is adopting an improper accounting method when it improperly capitalizes a repair expense (see, for example, Chief Counsel Advice 201231004, April 18, 2012). To change from an improper capitalization of a repair expense and from an improper deduction of a capital expenditure, taxpayers use Change 184 of Rev. Proc. 2014-16.

CAUTION! The election works in only one direction. Amounts that are expensed as repairs on the taxpayer's books may not be deducted

as repairs for tax purposes under the protection of the book capitalization safe harbor. Repair deductions claimed for tax purposes must be allowable under the standards set forth in the repair regulations.

The election does not apply to amounts paid for repairs or maintenance of rotable or temporary spare parts that are covered by the taxpayer's use of the optional method of accounting under Reg. §1.162-3(e) (Reg. §1.263(a)-3(n)(3)).

MAKING THE ELECTION

The election is made by attaching a statement to the taxpayer's timely filed original tax return (including extensions) for the tax year to which the election applies (Reg. §1.263(a)-3(n)(2)). An election statement is available in the CCH Election and Compliance Toolkit on IntelliConnect.

If a taxpayer wanted to make the election to follow its book capitalization policy for a tax year beginning on or after January 1, 2012, and ending on or before September 19, 2013, and the taxpayer did not make the election on its timely filed original tax return for that tax year, the final regulations allowed a taxpayer to make the election by filing an amended return on or before 180 days from the due date, including extensions (even if no extension was requested), of the taxpayer's tax return for the tax year (Reg. §1.263(a)-3(r)(2)(ii)).

ACCOUNTING METHOD CHANGE NOT REQUIRED

The election to capitalize in accordance with books is not an accounting method (Reg. §1.263(a)-3(n)(2)).

7. Safe Harbor For Taxpayers With Low-Cost Buildings

KEY CHANGES TO TEMPORARY REGULATIONS:

- A new safe harbor allows taxpayers with $10 million or less in annual gross receipts to deduct a limited amount of improvement expenditures on qualifying buildings.

GENERAL RULES

Small taxpayers complained that they could not afford to collect and maintain the documentation necessary to apply the improvement rules in the final temporary regulations to their buildings. In response, the final regulations include an annual safe harbor election for each building a taxpayer owns or leases that has an unadjusted basis no greater than $1 million (Reg. §1.263(a)-3(h)(3)).

Unadjusted basis is determined under Code Sec. 1012 and is generally equal to cost unreduced by depreciation, including the Code Sec. 179 deduction (Reg. §1.263(a)-3(h)(5)).

Under the safe harbor, the small taxpayer is not required to capitalize improvements if the total amount paid for repairs, maintenance, and improvements during the year does not exceed the lesser of $10,000, or two percent of the unadjusted basis of the building.

COMMENT. The IRS may adjust the $10,000, two percent, and $1 million amounts in the future through published guidance.

If the total of repairs and improvements for the building exceeds $10,000 or two percent of the unadjusted basis of the building, the safe harbor does not apply (Reg. §1.263(a)-3(h)(8)).

Amounts deducted under the de minimis safe harbor or the safe harbor for routine maintenance are counted toward the $10,000 limit (Reg. §1.263(a)-3(h)(2)).

A small taxpayer is a taxpayer with average annual gross receipts of $10 million or less during the three preceding tax years. Gross receipts are specially defined and include income from sales (unreduced by cost of goods), services, and investments (Reg. §1.263(a)-3(h)(3)(iv)).

In the case of a lessee, the unadjusted basis of a leased building (or leased building space) is equal to the total amount of (undiscounted) rent paid or expected to be paid over the entire lease term, including expected renewal periods (Reg. §1.263(a)-3(h)(5)(ii)).

> **EXAMPLE.** A taxpayer enters into a 20-year lease of a building in which it operates a retail store. If the monthly rent is $4,000, the unadjusted basis of the building is $960,000 ($4,000 × 12 months × 20 years). The safe harbor may be elected if the taxpayer satisfies the gross receipts test (Reg. §1.263(a)-3(h)(10), Ex. 4).

The safe harbor is elected separately for each building owned or leased by the taxpayer.

> **EXAMPLE.** A taxpayer owns two rental properties, each with an unadjusted basis of $300,000. The taxpayer pays $5,000 of repair and improvement expenses in 2014 on building A. Since this amount does not exceed the lesser of $10,0000 or $6,000 ($300,000 × 2%), the taxpayer may elect to apply the safe harbor to building A. If the taxpayer pays $7,000 on building B, the election may not be made for that building because $7,000 is greater than 2% of building B's unadjusted basis (Reg. §1.263(a)-3(h)(10), Ex. 3).

ELIGIBLE BUILDING PROPERTY

The safe harbor applies to "eligible building property." Eligible building property is defined as each unit of property that (i) is a building (including structural components and building systems) or portion of a building that is a separate unit of property under the regulations, such as leased office space or an individual condominium or cooperative unit, and (ii) has an unadjusted basis of $1 million or less (Reg. §1.263(a)-3(h)(4)).

> **PLANNING TIP.** The cost of personal property identified in a cost segregation study should not be counted toward the unadjusted basis of a building under a strict construction of the regulations, since each item of such personal property is a separate unit of property and not part of the building unit of property (Reg. §1.263(a)-3(e)

(5)(ii)). Consequently, an additional benefit of a cost segregation study is that it could allow a building to qualify for the safe harbor.

The safe harbor does not apply to costs paid with respect to exterior land improvements that are separate units of property.

MAKING THE ELECTION

The election is made annually on a timely filed (including extensions) original income tax return. In the case of a partnership or S corporation that owns or leases a building, the partnership or S corporation makes the election. The election may not be made on an amended return unless permission to file a late election on an amended return is first obtained. The election is irrevocable (Reg. §1.263(a)-3(h)(6)).

An election statement is required. A sample election statement is provided in the CCH Election and Compliance Toolkit on IntelliConnect.

A taxpayer was allowed to make the election for amounts paid or incurred in a tax year beginning on or after January 1, 2012, and ending on or before September 19, 2013, if the election was not made on a timely filed original federal tax return. The election was made by filing an amended return on or before 180 days from the due date, including extensions (even if no extension was requested), of the taxpayer's 2012 or 2013 return, as applicable (Reg. §1.263(a)-3(r)(2)(ii)).

ACCOUNTING METHOD CHANGE NOT REQUIRED

The safe harbor for small taxpayers is not an accounting method (Reg. §1.263(a)-3(h)(6)).

8. Taxpayers Subject To FERC, FCC, STC

GENERAL RULES

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 (Reg. §1.263(a)-3(m)).

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 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.

ACCOUNTING METHOD CHANGE

The optional regulatory accounting method is an accounting method change that requires a cumulative Code Sec. 481(a) adjustment (Reg. §1.263(a)-3(m)(3)). The change is made under Rev. Proc. 2014-16, as change 185.

9. Amounts Paid To Acquire or Produce Tangible Property

KEY CHANGES TO TEMPORARY REGULATIONS:

- The final regulations make no significant changes to the temporary regulations relating to the requirements to capitalize amounts paid to acquire or produce a unit of real or personal property.
- However, the final regulations define a contingency fee and provide that such fees are capitalized only if property is ultimately acquired.

GENERAL RULES

Although not related to the "repair v. capitalization" issue, the final regulations include rules explaining the types of costs that must be capitalized as amounts paid to acquire or produce a unit of tangible property (Reg. §1.263(a)-2).

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.

"Produce" means to construct, build, install, manufacture, develop, create, raise, or grow. This definition is identical to the definition under the uniform capitalization (UNICAP) rules, except that the term does not include "improving a property." The requirement to capitalize improvements is separately covered in Reg. §1.263(a)-3 which breaks improvements down into betterments, restorations, and adaptations.

The acquisition costs of materials and supplies are not capitalized. Instead, the cost is typically deducted when the material or supply is used or consumed. Materials and supplies used to improve a property, however, are capitalized under Code Sec. 263 and, if used to produce a property, are generally a direct or indirect cost that must be capitalized under the UNICAP rules of Code Sec. 263A.

Amounts paid or incurred to acquire or produce a unit of property include:

- Invoice price;
- Transaction costs; and
- Costs for work performed prior to the actual date that the unit of property is placed in service (Reg. §1.263(a)-2(d)(1)).

COMPLIANCE NOTE. 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 UNICAP rules 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 can includes repairs, installation costs, and testing costs (Reg. §1.263(a)-2(d)(1)). For example, repairs to a building before it is placed in service are capitalized along with the cost of any improvements (Reg. §1.263(a)-2(d)(1) and (d)(2), Ex. 10).

RECOVERY OF CAPITALIZED AMOUNTS

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 (Reg. §1.263(a)-2(g)).

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 (Reg. §1.263(a)-2(h)).

FACILITATIVE ACQUISITION COSTS

An amount that, 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, 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 (Reg. §1.263(a)-2(f)(2)). The fact that the amount would (or would not) have been paid or incurred but for the acquisition is relevant but is not determinative.

The following costs are "inherently facilitative" and, therefore, must be capitalized (Reg. §1.263(a)-2(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 contingency fees;
- Architectural, geological, engineering, environmental and inspection services pertaining to particular properties; and
- Services provided by a qualified intermediary or other facilitator of a Code Sec. 1031 like-kind exchange.

Coordination with other provisions. An inherently facilitative amount is not capitalized to the cost of the property if an alternative treatment is provided in the Code (Reg. §1.263(a)-2(c)). For example, the cost of geological and geophysical studies to determine if a property is suitable for oil and gas production is inherently facilitative but should be separately capitalized and amortized as required by Code Sec. 167(h) (Reg. §1.263(a)-2(f)(4), Ex. 4). Inherently facilitative amounts may also qualify for deduction and amortization as start-up costs under Code Sec. 195.

Facilitative amounts for failed acquisitions. 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) (Reg. §1.263(a)-2(f)(3)(ii)).

Contingency fees. The final regulations clarify that a contingency fee may be deducted if the real or personal property is not acquired. For this purpose, a contingency fee as an amount paid that is contingent on the successful closing of an acquisition of real or personal property. If the property is acquired, the contingency fee must be included in basis (Reg. §1.263(a)-2(f)(3)(ii)).

EXAMPLE. Yazzo decides to open a new restaurant in Junction City and contracts with a real estate consultant to identify three possible locations. The consultant receives a fee only if Yazzo purchases one of the properties. Yazoo does purchase one of the properties. The contingency fee must be included in the basis of the acquired property and may not be allocated among the three properties (Reg. §1.263(a)-2(f)(4), Ex. 4).

COMPLIANCE NOTE. The final 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, 2014, or, optionally, on or after January 1, 2012 (Reg. §1.263(a)-2(k)).

PRE-DECISIONAL (WHETHER AND WHICH) COSTS FOR REAL PROPERTY ARE DEDUCTIBLE

An amount that is paid or incurred in the process of investigating or otherwise pursuing the acquisition of real property, but 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 these costs between the personal property and real property (Reg. §1.263(a)-2(f)(2)(iii)).

COMPLIANCE NOTE. This rule is also effective for amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2014, or on or after January 1, 2012 (Reg. §1.263(a)-2 (j)).

Example. Redball Express owns several retail stores and hires a consulting firm in 2014 to examine the feasibility of opening a new store in Junction City. The consulting firm performs market surveys, evaluates zoning and environmental requirements, and recommends two possible locations for a new store. In 2014, Redball also obtains appraisals on the two recommended sites. In 2015, Redball decides to acquire one of the two sites. The consulting firm costs incurred in 2014 were incurred to determine whether to open a new store and which location to choose. Since these "whether or which" costs are not inherently facilitative costs, they may be currently deducted. The appraisal costs incurred in 2014 are capitalized because they are inherently facilitative. In 2015, Redball may claim a loss deduction on the appraisal fees that are allocable to the site it did not purchase. The remaining fees are included in the basis of the acquired site (Reg. §1.263(a)-2(f)(2)(iii), Ex. 8).

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, the UNICAP rules of 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 (Reg. §1.263(a)-2(f)(2)(iv)(C)).

A taxpayer may elect to capitalize amounts paid or incurred for employee compensation as 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. The election is made by capitalizing the elected amounts on the taxpayer's timely filed original return (including extensions) for the tax year the costs were paid or incurred. No election statement is required (Reg. §1.263(a)-2(f)(2)(iv)(B)).

This election is not an accounting method change.

If a taxpayer wanted to capitalize employee compensation and overhead costs for a tax year beginning on or after January 1, 2012, and ending on or before September 19, 2013, and the taxpayer did not make the election on its timely filed original federal tax return for the tax year, the election was allowed to be made by filing an amended return on or before 180 days from

the due date, including extensions (even if no extension was requested), of the taxpayer's tax return for the tax year (Reg. §1.263(a)-2(j)(2)).

> **COMPLIANCE NOTE.** The election to capitalize employee compensation and overhead is effective for amounts paid or incurred to acquire or produce property in tax years beginning on or after January 1, 2014, or optionally, tax years beginning on or after January 1, 2012 (Reg. §1.263(a)-2(j)).

MOVING AND REINSTALLATION COSTS

Amounts paid to move and reinstall a unit of property that has already been placed in service do not have to be capitalized under the rules for acquisition or production of property. However, moving and reinstallation costs must be capitalized if they directly benefit or are incurred by reason of an improvement to the moved and reinstalled property.

DEFENDING OR PERFECTING TITLE

Amounts paid or incurred to defend or perfect title to real or personal property are capitalized (Reg. §1.263(a)-2(e)(1)). For example, attorney's fees paid or incurred 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 are incurred to defend title and must be capitalized (Reg. §1.263(a)-2(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 (Reg. §1.263(a)-2(e)(2), Ex. 2).

ACCOUNTING METHOD CHANGES

An election to capitalize employee compensation and overhead is not a change in accounting method (Reg. §1.263(a)-2(f)(2)(iv)(B)). Otherwise, a change to comply with Reg. §1.263(a)-2 is a change in accounting method (Reg. §1.263(a)-2(i)).

For taxpayers applying the final regulations, Rev. Proc. 2014-16 adds the followings automatic accounting method changes relating to costs to acquire or produce property to the Appendix of Rev. Proc. 2011-14 (IRB 2011-4, 330):

- A change to capitalizing amounts paid or incurred to acquire or produce property in accordance with Reg. §1.263(a)-2, and if depreciable, to depreciating such property under section Code Secs. 167 or 168 (change 192);
- A change to deducting amounts paid or incurred in the process of investigating or otherwise pursuing the acquisition of real property (Reg. §1.263(a)-2(f)(2)(iii)) (change 193) (cut-off method applies); and
- A change from capitalizing to deducting employee compensation and overhead costs incurred to investigate acquisition of real property (Reg. §1.263(a)-2(f)(2)(iv)) (change 193) (cut-off method applies).

Overview

Historically, a taxpayer that retired a structural component of a building could not treat the retirement as a disposition and take a loss. Instead, the taxpayer had to continue depreciating the retired component (e.g., old roof) and begin depreciating the replacement component (e.g. new roof).

Temporary MACRS regulations, issued in conjunction with the repair regulations, however, treated the retirement of a structural component as a disposition of an asset and required a taxpayer to claim a loss equal to the remaining adjusted basis of the retired structural component (Temp. Reg. §1.168(i)-8T(b)(1)). This rule could have an adverse impact because the temporary repair regulations required the capitalization of amounts paid for the replacement of a component of property that might otherwise be deductible as a repair if a loss was claimed for the replaced component (Temp. Reg. §1.263(a)-3(i)(1)(i)). For example, if a single window (a structural component) was replaced, the cost was not a repair expense if a loss was claimed.

To alleviate this result, the temporary MACRS regulations revised the rules for MACRS general asset accounts (GAAs). Under the revised rules, a taxpayer that placed a building or other asset in a GAA was not required to claim a loss on the retirement of a structural or other component that was considered an asset unless an affirmative election was made to treat the retirement as a "qualifying disposition." Previously, this election for qualifying dispositions was available only in a few select circumstances. The temporary regulations expanded this election to virtually any disposition (Temp. Reg. §1.168(i)-1T(e)(3)(iii)).

IMPACT. Assuming an asset was placed in a GAA, under the temporary regulations a taxpayer could base the decision on whether or not to elect to treat a retirement of a component of the asset (such as a structural component of a building) as a qualifying disposition on whether or not the replacement costs constituted deductible repair expenses. If the replacement costs were deductible repairs, then generally no qualifying disposition election would be made since the loss deduction would prevent the taxpayer from deducting the repair expenses.

Rev. Proc. 2012-20 (I.R.B. 2012-14, 700) allowed taxpayers to file accounting method changes to make retroactive GAA elections for buildings and other assets placed in service in tax years beginning before January 1, 2012. In addition, retroactive qualifying disposition elections could be made for previously retired structural components and components of section 1245 propertyin a GAA, including GAA accounts that were retroactively established (Sec. 5.04(6) of Rev. Proc. 2012-20).

These disposition rules in the temporary regulations for assets in and outside of GAA accounts seemed unduly complicated and burdensome to many practitioners. A similar result could be achieved by simply making the recognition of gain or loss on the retirement of structural and other components outside of a GAA elective.

The IRS listened and replaced the temporary regulations with proposed regulations that created a "partial disposition" election for assets that are not in general asset accounts (Proposed. Reg. §1.168(i)-8(d), now final Reg. §1.168(i)-8(d)). If the election is made, a taxpayer may recognize a loss on the retirement of a structural component (e.g., a roof) or any component of a structural component (e.g., the shingles on a roof). The election also applies to components of property other than buildings, such as components of machinery. If the election is not made, the taxpayer does not claim a loss and continues to depreciate the basis of the retired component.

> **COMMENT.** The proposed MACRS regulations governing dispositions (Proposed Reg. §1.168(i)-8)) and general asset accounts (Proposed Reg. §1.168(i)-1) were adopted as final regulations without significant change by T.D. 9636 (9/13/2013). This discussion will generally only cite the final regulations.

The final regulations also modify the GAA rules in the temporary regulations to redefine a qualifying disposition for which an election may be made to recognize a gain or loss. A qualifying disposition that is eligible for the election under the final regulations now includes only the few select types of dispositions that were treated as qualifying dispositions under the rules that applied before the temporary and final regulations were issued.

> **IMPACT.** Under the final regulations, a taxpayer may not elect to recognize loss on the retirement of a structural component of a building in a GAA. Consequently, taxpayers should generally not place buildings in a GAA. Furthermore, taxpayers that made retroactive GAA elections or timely GAA elections for buildings placed in service in a tax year beginning in 2012 or 2013 will likely want

to revoke those elections by filing an accounting method change provided in Rev. Proc. 2014-54 and discussed below (change 197).

For a detailed analysis of the disposition rules under the temporary regulations, see the CCH Tax Briefing entitled “Updated: Analysis of 2012 Comprehensive Repair/Capitalization Regulations (Nov. 30, 2012).

10. Dispositions of MACRS Property

KEY CHANGES TO TEMPORARY REGULATIONS:

- New partial disposition election allows taxpayers to treat the retirement of structural components, components of structural components, and components and subcomponents of assets such as machinery as a disposition on which gain or loss (usually loss) is recognized.
- Taxpayers may file accounting method change to make late partial disposition election for assets placed in service in tax years beginning before January 1, 2012 and must make this late election to preserve retirement losses previously claimed under the temporary regulations.

A disposition of MACRS property occurs when ownership of an asset is transferred or when the asset is permanently withdrawn from use in the taxpayer's trade or business or for the production of income. A disposition occurs when an asset is:

- Sold;
- Exchanged;
- Retired;
- Physically abandoned;
- Destroyed; or
- Transferred to a supplies, scrap, or similar account (Reg. §1.168(i)-8(b)(2)).

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 whether gain or loss is recognized (Reg. §1.168(i)-8(c)(1)).

A disposition of a portion of an asset (e.g. structural component of a building or a portion of a structural component) can be treated as a disposition if the partial disposition election described below is made (Reg. §1.168(i)-8(d)). However, partial dispositions in certain types of transactions, such as a casualty loss or a sale, must be treated as dispositions that trigger gain or loss.

COMMENT. Generally, in order for gain or loss to be recognized under the final regulations, an entire "asset" must be disposed of unless the disposition is a sale or a partial disposition election is made. An asset for this purpose is defined below, and is not necessarily the same as a unit of property. In the case of a building, the entire building is usually the asset. Consequently, the retirement of a structural component (or portion of it) is not the disposition of an asset that triggers recognition of a loss unless a partial disposition election is made. Under the temporary regulations, each structural component was treated as an asset.

ASSET DEFINED FOR DISPOSITION PURPOSES

The facts and circumstances of each disposition are considered in determining what is the appropriate asset disposed of. The unit of property definition used for purposes of determining whether a cost is a repair or capital expenditure (Reg. §1.263(a)-3(e)) does not apply (Reg. §1.168(i)-8(c)(4)(i)).

Items placed in service on different dates, such as additions or improvements to an asset, are separate assets. For example, although a building is an asset, a new roof placed on a building is a separate asset (Reg. §1.168(i)-8(c)(4)(i)). The new roof, however, is not a separate unit of property. The building, including the new roof, is the unit of property.

Buildings. Each building, condo unit, or cooperative unit, including its structural components, is an asset (Reg. §1.168(i)-8(c)(4)(ii)).

An exception applies where two or more buildings (or condos or cooperative units) on a single tract or parcel of land are operated as an integrated unit and treated as a single item of section 1250 property for recapture purposes under current regulations (Reg. §1.1250-1(a)(2)(ii)).

COMMENT. Under the temporary regulations, each structural component of a building (or condo or coop unit) was a separate asset for disposition purposes, and loss had to be recognized on the component's retirement unless the building was placed in a GAA where recognition of loss was elective. Subject to limited exceptions, under the final regulations, the retirement of a structural component (or portion thereof) generates a loss only if the building is not in a GAA and the partial disposition election is made.

EXAMPLE. A taxpayer owns an office building with four elevators. The taxpayer replaces an elevator, which is a structural component. Under the temporary regulations, the elevator (a structural compo-

nent) was an asset and the retirement was a disposition. The taxpayer had to recognize a loss upon the retirement equal to the adjusted basis of the replaced elevator unless the elevator was in a GAA and the taxpayer made a qualifying disposition election (Temp. Reg. §1.168(i)-8T(h), Ex. 1). Under the final regulations, the retirement is not a disposition and the taxpayer does not recognize a loss unless a partial disposition election is made (Reg. §1.168(i)-8(i), Exs. 1, 2 and 3).

PLANNING TIP. Since the cost of the new elevator is likely to be considered a capital expenditure (because a major component of the elevator building system has been replaced), the taxpayer should make the partial disposition election and claim a retirement loss on the adjusted basis of the replaced elevator. If the replaced elevator is original equipment, a portion of the cost of the building will need to be allocated to it in order to determine the allowable loss.

Property described in Rev. Proc. 87-56 and Code Sec. 168(e)(3). Items described in any of the asset classes 00.11 through 00.4 of Rev. Proc. 87-56 (87-2 CB 674) and in Code Sec. 168(e)(3) (other than buildings and structural component) are separate assets (Reg. §1.168(i)-8(c)(4)(ii)).

Rev. Proc. 87-56 provides MACRS recovery periods for most assets. Asset Classes 00.11 through 00.4 describes the following commonly-used 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) provides recovery periods for 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 (such as 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 two-way exchange of voice and data communications; and section 1245 property used in the transmission at 69 or more kilovolts of electricity for sale.

CAUTION! A loss deduction can be claimed on the retirement of a component of an asset described in Asset Classes 00.11 through 00.4 or in Code Sec. 168(e)(3) if the partial disposition election is made. In that case, however, the cost of replacing the component cannot be deducted as a repair expense. As explained earlier, the cost of replacing a component is capitalized as a restoration if a loss is claimed on the retired component.

EXAMPLE. A company owns a truck described in Asset Class 00.241 of Rev. Proc. 87-56. Thus, the truck is treated as an asset for tax disposition purposes and the replacement of the engine is not a disposition unless the partial disposition election is made. If no election is made, when an engine is replaced, the company continues to depreciate the truck (including the replaced original engine) and no loss is recognized upon the replacement. The new engine, however, is a separately depreciated asset with the same recovery period as the truck but is part of the unit of property which is the entire truck (Reg. §1.168(i)-8(i)), Ex. 6).

Property not described in Asset Classes 00.11 through 00.4 and Code Sec. 168(e)(3). For property other than buildings, property described in Asset Classes 00.11 through 00.4, and property described in Code Sec. 168(e)(3), the facts and circumstances test applies in determining the asset, subject to the restriction that prevents a taxpayer from treating two items that are placed in service at different times as one asset.

COMMENT. The temporary regulations provided that if an asset is not described in one of the asset classes 00.11 through 00.4 or in one of the categories under Code Sec. 168(e)(3), a taxpayer could use any reasonable, consistent method to treat each of the asset's components as the asset disposed of (Temp. Reg. §1.168(i)-8T(c)(4)). The final regulations drop this rule because a taxpayer may effectively treat any component of any asset as a separate asset by making the partial disposition election (Reg. §1.168(i)-8(d)).

Additions and improvements. A capitalized improvement or addition added to an asset after the taxpayer places the asset in service is a separate asset for depreciation purposes (Reg. §1.168(i)-8(c)(4)(ii)(D)). Since the addition or improvement is a separate asset, a loss must be recognized on its retirement. The partial disposition election does not apply because an entire asset is disposed of.

EXAMPLE. The roof of a building is replaced and capitalized as an improvement. The replacement roof is considered a separate asset because it is an addition or improvement. It is not, however, a separate unit of property. The building, including the new roof, is a unit of property. When the replacement roof is removed, a loss must be recognized because the entire asset has been disposed of. The partial disposition election is not necessary and does not apply. The partial disposition election, however, could apply to a portion of the replacement roof, such as its shingles, if they are later replaced. The new shingles would then be considered a separate depreciable asset.

PARTIAL DISPOSITION ELECTION

The general concept of the partial disposition election has already been discussed. Here are the details.

A disposition of a portion of an asset is treated as a disposition on which gain or loss is realized only if the partial disposition election is made, except that the following dispositions of a portion of an asset are dispositions without making a partial disposition election:

- Sale of a portion of an asset;
- Disposition of a portion of an asset as the result of a casualty;
- Disposition of a portion of an asset for which gain (determined without regard to depreciation recapture) is not recognized in a like kind exchange or involuntary conversion; and
- Transfer of a portion of an asset in a "step-in-the-shoes" nonrecognition transaction described in Code Sec. 168(i)(7)(B) (Reg. §1.168(i)-8(c)(4)(ii)(D)).

The partial disposition election may be made for any disposed of portion of an asset regardless of how small the portion is.

If a taxpayer makes the election with respect to an asset described in MACRS asset classes 00.11 through 00.4, the replacement part is considered in the same asset class as the asset. For example, the replaced engine on a car (asset class 00.2) is also in asset class 00.2. This means that the engine must be depreciated over the same recovery period as the car (i.e., as 5-year MACRS property) (Reg. §1.168(i)-8(d)(2)(i)). Without explanation, the final regulations do not explicitly extend this requirement to other asset classes in Rev. Proc. 87-56 and assets described in Code Sec. 168(e)(3).

COMMENT. The IRS explains that the rule is consistent with Code Sec. 168(i)(6), which requires an addition or improvement to be depreciated in the same manner as the deduction on the improved property would be computed if the improved property had been placed in service at the same time as the addition or improvement. Insofar as Code Sec. 168(i)(6) applies to all additions and improvements, it is unclear why the IRS limited application of the rule in the final regulations to asset classes 00.11 – .04 and did not extend it to assets described in Code Sec. 168(e)(3) or to any other asset class in Rev. Proc. 87-56.

Computing remaining adjusted basis. If a taxpayer makes the partial disposition election or the transaction is otherwise considered a partial disposition (because it is a sale, a disposition as the result of a casualty event, etc.), the adjusted basis of the disposed portion of the asset at the time of disposition needs to be computed to determine gain or loss. The taxpayer must determine the adjusted basis using its records if that is practicable. If it is impracticable, any reasonable method may be used to determine the unadjusted depreciable basis of the disposed portion (i.e., the portion of the original cost of the asset that is allocable to the disposed-of portion), including the following:

- Discounting the cost of the replacement portion of the asset to its placed-in-service year cost using the Producer Price Index for Finished Goods or its successor, the Producer Price Index for Final Demand;
- 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 (Reg. §1.168(i)-8(f)(3).

CAUTION! The most important difference between the proposed regulations and the final regulations is that the proposed regulations allowed taxpayers to use the consumer price index to compute the unadjusted basis of the disposed portion of an asset (Proposed Reg. §1.168(i)-8(f)(3). The final regulations declared the use of the consumer price index unreasonable. Taxpayers that used the consumer price index to compute unadjusted basis are required to file an accounting method change to recompute unadjusted basis using the producer price index or some other reasonable method (Change 205 for buildings not in a GAA, 206 for section 1245 property and land improvements not in a GAA, 207 for buildings or section 1245 property and land improvements in a GAA). For

purposes of computing the adjusted basis of the disposed-of portion of the asset, the depreciation allowed or allowable is computed using the same method, recovery period, and convention that apply to the asset that included the disposed-of portion. The basis of the disposed-of asset should also be reduced by an allocable share of any bonus depreciation (Reg. §1.168(i)-8(f)(3)).

EXAMPLE. In March 2014, a taxpayer replaces an elevator in a building (39-year MACRS property subject to the mid-month convention) that was placed in service in January 2011. The taxpayer also makes a timely partial disposition election. To determine the retirement loss, the taxpayer must make a reasonable allocation of the original cost of the building to the elevator, and then determine the depreciation that was claimed on that allocated cost from January 2011 through March 2014, using a 39-year recovery period and the mid-month convention. Assuming that it is impracticable to determine the allocation using the taxpayer's own records, the allocation can be made by discounting the cost of the new elevator with reference to the placed-in-service year of the original elevator using the Producer Price Index for Final Demand. The new elevator is a separate asset that must be depreciated using a 39-year recovery period and the mid-month convention beginning in March 2014 (Reg. §1.168(i)-8(i), Ex. 9).

Partial disposition election procedure. The partial disposition election must be made by the due date (including extensions) of the original federal tax return for the tax year in which the portion of the asset is disposed of. No formal election statement is required. The taxpayer simply reports the gain or loss on the disposed portion of the asset on the return (Reg. §1.168(i)-8(d)(2)(ii)).

The election may be revoked only with IRS consent obtained by filing a letter ruling request (Reg. §1.168(i)-8(d)(2)(v)).

PLANNING TIP. A taxpayer may deduct removal costs if a partial disposition election is made (Reg. §1.263(a)-3(g)).

Retroactive partial disposition election based on adverse audit result. If the IRS audits a taxpayer and determines that an amount previously claimed as a repair deduction should have been capitalized, the taxpayer may make a retroactive partial disposition election by filing an accounting method change (Change 198) to claim a loss through a Code Sec. 481(a) adjustment on the portion of the asset that was disposed of. The taxpayer, however, must own the asset as of the beginning of the tax year of change (Reg. §1.168(i)-8(d)(2)(iii)).

EXAMPLE. John Grant replaces the entire roof of a building and claims a repair loss. He does not make the partial disposition election to claim a loss on the retired roof because under the repair regulations, a repair deduction cannot be claimed if a loss is claimed on a retired component (Reg. §1.263(a)-3(k)(1)(i)). Three years later the IRS audits the return and disallows the repair deduction. John Grant may file an application for a change in accounting method and make the partial disposition election to claim a loss through a Code Sec. 481(a) adjustment. The adjustment is equal to the remaining undepreciated basis of the retired roof at the beginning of the year of change.

Partial disposition elections for retirements in 2012 and 2013 tax year. A taxpayer was allowed to make a partial disposition election for dispositions in tax years beginning on or after January 1, 2012, and ending on or before September 19, 2013, on an amended return if the election was not made on the taxpayer's timely filed original return. The amended return must be filed on or before 180 days from the due date of the 2012 or 2013 return (including extensions even if no extension was requested) (Reg. §1.168(i)-8(d)(2)(iv)).

Alternatively, such a taxpayer may file Form 3115 with a timely filed original return for the first or second tax year succeeding the 2012 or 2013 tax year and claim a Code Sec. 481(a) adjustment for partial dispositions that took place in 2012 or 2013 (Reg. §1.168(i)-8(d)(2)(iv)). Rev. Proc. 2014-54 provides an automatic change method to make this change for 2012 and 2013 dispositions (Change 196).

Taxpayers that do not qualify under the amended return or accounting method change rules for 2013 tax year dispositions were required to make a timely partial disposition election on their 2013 tax return for partial dispositions that occurred in the 2013 tax year. For example a calendar year taxpayer that retired a roof in 2013 and did not make a timely partial disposition election under the proposed or final regulations may not now file an amended return or an accounting method change to make a late partial disposition to claim a loss on the roof.

COMMENT. For a partial disposition of an asset that took place in a 2012 calendar tax year, a taxpayer may file Form 3115 in the 2013 or 2014 tax year (the first or second tax year following the disposition year) to make a late partial disposition election and compute a Code Sec. 481(a) adjustment equal to the remaining undepreciated basis as of the year of change.

Late partial disposition election for tax years beginning before January 1, 2012. A taxpayer may also make a retroactive partial disposition election for partial dispositions that occurred in tax years beginning before January 1, 2012 by filing an accounting method change pursuant to Rev. Proc. 2014-54 (Change 196). This change needs to be filed for a tax year that begins on or after January 1, 2012 and before January 1, 2015. This means a calendar-year taxpayer must make the change no later than for the 2014 tax year.

> **CAUTION!** Under the temporary regulations, taxpayers could file a change of accounting method under Rev. Proc. 2012-20 with a Code Sec. 481(a) adjustment that took into account losses on all previously retired structural components (that were not fully depreciated). Taxpayers will need to file an accounting method change to make a late partial disposition election in order to preserve these retirement losses (Change 196). Rev. Proc. 2012-20 also allowed a taxpayer to make retroactive GAA elections for buildings (and other assets) placed in service in a tax year beginning before January 1, 2012 and retroactive qualifying disposition elections with respect to such property to claim losses on particular retirements that occurred in prior tax years. Taxpayers that made retroactive GAA elections or timely GAA elections for the 2012 or 2013 tax year will now usually want to revoke those elections by filing an accounting method change (Change 197) and, to preserve the losses, file a concurrent accounting method change to make a late partial disposition election (Change 196). These accounting method changes are allowed by Rev. Proc. 2014-54 as explained later.

EFFECTIVE DATE

The final MACRS regulations, including Reg. §1.168(i)-8, apply to tax years beginning on or after January 1, 2014. A taxpayer may apply the final regulations to tax years beginning on or after January 1, 2012, and before January 1, 2014 (Reg. §1.168(i)-8(j). A taxpayer may apply the proposed or temporary regulations to a tax year beginning on or after January 1, 2012 and before January 1, 2014, but is not required to do so. At this point in time, taxpayers would generally only file accounting method changes to apply the final regulations to such tax years if the filing deadline for making the change has not expired. The filing deadline is the extended due date of the income tax return for the year of change.

ACCOUNTING METHOD CHANGES

The partial disposition election is not an accounting method except that (as noted above) the IRS allows certain retroactive elections for assets placed in service in tax years beginning before January 1, 2012, and in tax years beginning on or after January 1, 2012 and ending on or before September 19, 2013, by filing an accounting method change as explained in more detail below. However, all other changes to comply with Reg. §1.168(i)-8 for depreciable assets placed in service in a tax year ending on or after December 30, 2003, are accounting method changes. A taxpayer may also treat a change to comply with Reg. §1.168(i)-8 for assets placed in service in a tax year ending on before December 30, 2003, as a change in accounting method (Reg. §1.168(i)-8(j)(5)). See the general discussion of accounting method changes later in this Special Report for the significance of the December 30, 2003 date.

11. MACRS General Asset Accounts

KEY CHANGES TO TEMPORARY REGULATIONS:

- Qualifying disposition election to recognize loss on retired structural components is eliminated.
- Revocation of retroactive GAA elections pre-2012 assets and timely 2012 and 2013 GAA elections allowed.
- Losses only recognized on partial dispositions resulting from a sale, casualty loss, and certain other dispositions that are not retirements.

The final (and proposed) regulations reverse the most significant change made by the temporary regulations to the general asset account (GAA) rules. Specifically, the expansion of the qualifying disposition election to virtually any disposition, which allowed a taxpayer to elect to recognize a loss on the disposition of an asset in a GAA including retirements of structural components, is eliminated. In addition, only certain partial dispositions of assets are made subject to a new mandatory gain or loss recognition rule. These include the same types of partial dispositions for which gain and loss recognition is mandatory under the rules discussed above that apply to dispositions outside of a GAA, (i.e., sales, casualty losses, etc.).

> **COMMENT.** The proposed GAA regulations were finalized without significant change (T.D. 9636 (9/13/2013)). This discussion will generally only make reference to the final regulations.

The final regulations follow the minor updating done by the temporary regulations to the original GAA regulations that reflect recent developments, such as bonus depreciation, and clarify that only identically depreciated assets may be placed in the same GAA.

The following discussion explains the general operation of a GAA under the final regulations and highlights changes to the temporary regulations and the GAA regulations in place prior to amendment by the temporary, proposed, and final regulations (i.e., the "original" GAA regulations).

RULES FOR GROUPING ASSETS INTO A GAA

Assets that may be grouped into a single GAA may be divided and placed into more than one GAA (Reg. §1.168(i)-1(c)(1)). For example, a taxpayer may create a separate GAA 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:

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 (Reg. §1.168(i)-1(c)(2)).

> **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. Some of the machines could also be placed in item or multiple asset accounts instead of a GAA.

> **COMMENT.** The original GAA rules allow assets only 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 (5-year property described in Asset Class 00.242) even though depreciation is computed identically on both items (Reg. §1.168(i)-1(c)(2), prior to amendment by the temporary, proposed, and final regulations). The final regulations do away with this limitation.

Assets that are subject to the mid-quarter convention may be placed in the same GAA account only 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 they are placed in service in the same month of the same 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. These types of property may not be placed in the same GAA because they have different recovery periods (39 years and 27.5 years).

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:

- Passenger automobiles subject to the luxury car depreciation limits of Code Sec. 280F must be grouped in a separate GAA;
- Other listed property (as defined in Code Sec. 280F(d)(4)) must be grouped into a separate GAA;
- Assets for which bonus depreciation was claimed may be grouped into a GAA only with assets for which a similar bonus depreciation rate applied;
- Assets for which the depreciation allowance for the placed-in-service year is not determined under an optional depreciation table must be grouped into a separate GAA; and
- Mass assets, the disposition of which will be identified by a mortality dispersion table, must be grouped in a separate GAA (Reg. §1.168(i)-1(c)(2)(ii)(C)-(I)).

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 (Reg. §1.168(i)-1(d)(1)).

> **EXAMPLE.** ABC Inc. places two machines costing $100,000 each in the same GAA in 2013. The machines are MACRS 3-year property depreciated using the 200-percent declining balance method and half-year convention. 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). The 2013 depreciation deduction for the GAA is $24,997.50 ($75,000 remaining adjusted depreciable basis × 33.33% first year table percentage); 2014 = $33,337.5 ($75,000 × 44.45%); 2015 = $11,107.50 ($75,000 × 14.81%); and 2016 = $5,557.50 ($75,000 × 7.41%).

DISPOSITION OF ASSET FROM GAA

Upon the disposition of an asset from a GAA that is not the last asset in the account, the following rules apply:

1. Immediately before the disposition, the asset is treated as having an adjusted depreciable basis of zero;
2. No loss is realized;
3. 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 the amount previously recognized as ordinary income; and
4. 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 (Reg. §1.168(i)-1(e)).

Generally, 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 Code (other than the ordinary income depreciation recapture provisions of Code Sec. 1245 and Code Sec. 1250 (Code Sec. 168(i)(4); Reg. §1.168(i)-1(e) (2) (i) and (ii)). Thus, the excess will generally be treated as section 1231 gain.

> **EXAMPLE.** EFG, a calendar-year corporation, maintains a GAA for 1,000 calculators (MACRS 5-year property subject to half-year convention). The calculators cost a total of $60,000 and are placed in service in 2014. No amount is expensed or claimed as bonus depreciation. Depreciation claimed in 2014 is $12,000 ($60,000 × 20% first-year table percentage). In 2015, EFG sells 200 of the calculators for $10,000. In 2015, EFG will recognize $10,000 as ordinary income. (The sold calculators have a deemed adjusted depreciable basis of zero). On its 2015 tax return, EFG recognizes $10,000 as ordinary income because this amount does not exceed the unadjusted depreciable basis of the general asset account ($60,000), plus any expensed cost for assets in the account ($0), less amounts previously recognized as ordinary income ($0). The unadjusted

depreciable basis and depreciation reserve of the account are not affected by the disposition of the calculators. Depreciation for 2015 is $19,200 ($60,000 × 32% second-year table percentage) (Reg. §1.168(i)-1(e)(3)(ii)(B), Ex. 1).

Upon the disposition of all of the assets or the last asset in a GAA, a taxpayer may make an election to terminate the account and recognize gain or loss by reference to the adjusted depreciable basis of the account (Reg. §1.168(i)-1(e)(3)(ii)). If the disposition does not involve all of the assets in the GAA account or the last asset, an alternative election for "qualifying dispositions" allows a taxpayer to remove the disposed-of asset from the GAA account and recognize gain or loss by reference to the asset's adjusted depreciable basis (Reg. §1.168(i)-1(e)(3)(iii)). Although most dispositions, including dispositions of structural components, were eligible for the qualifying disposition election under the temporary regulations, only a few specified types of dispositions are qualifying dispositions under the final regulations. These are same types of dispositions that are treated as qualifying dispositions under the original GAA regulations.

Dispositions of a portion of an asset. Under the final regulations, the disposition of a portion of an asset in a GAA (e.g., a structural component of a building or component of an item of section 1245 property, such as machinery) is not a disposition except in the following limited circumstances:

- A sale of a portion of an asset;
- A disposition of a portion of an asset as a result of a casualty event;
- A disposition of a portion of an asset for which gain (other than gain under Code Sec. 1245 or Code Sec. 1250) is not recognized in whole or in part under Code Sec. 1031 (like-kind exchanges) or Code Sec. 1033 (involuntary conversions);
- A transfer of a portion of an asset in a step-in-the-shoes transaction described in Code Sec. 168(i)(7)(B);
- A disposition of a portion of an asset in a transaction subject to the anti-abuse rule of Reg. §1.168(i)-1(e)(3)(vii)(B);
- A disposition of a portion of an asset if the taxpayer makes the election to terminate the GAA in which the disposed-of portion is included when all of the assets or the last asset in the account is disposed of; or
- The disposition of the portion of the asset is a "qualifying disposition," if the taxpayer makes the qualifying disposition election to recognize gain or loss by reference to the adjusted basis of the asset (Reg. §1.168(i)-1(e)(1)(ii)).

> **COMMENT.** Gain or loss must be recognized on most of these types of dispositions if the asset is not in a GAA, as previously discussed under the partial disposition election rules.

Determining asset disposed of. For a multiple asset GAA, the facts and circumstances of each disposition are considered in determining what is the appropriate asset disposed of. Each building, including its structural components, is a separate asset. Additions and improvements made to an asset after it is placed in service are separate assets (Reg. §1.168(i)-1(e)(2)(viii)).

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 (Reg. §1.168(i)-1(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; and
- The disposition of a portion of an asset under the circumstances described above, e.g., casualty loss, sale, etc.

> **EXAMPLE.** DEF maintains one GAA for an office building that cost $10 million. DEF replaces the entire roof. The office building is the asset and the retirement of the roof is not a disposition of an asset, nor does it qualify as a disposition of a portion of an asset as described above for casualty events, sales, etc. DEF must continue 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 (Reg. §1.168(i)-1(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 to terminate GAA treatment for the asset as of the first day of the tax year, and determine the amount of gain, loss, or other deduction by taking into account the asset's adjusted depreciable basis at the time of the disposition. The election is made on the timely filed (including extensions) original return for the year of disposition (Reg. §1.168(i)-1(e)(3)(iii)(A)).

PLANNING TIP. 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 any section 179 deduction) 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 Code as if the asset was not in a GAA.

Under the final regulations, a qualifying disposition is a disposition that does not involve all the assets or the last asset remaining in the GAA and is any of the following:

- A direct result of a fire, storm, shipwreck, or other casualty, or from theft;
- A charitable contribution for which a deduction is allowable;
- A direct result of the termination of a business; or
- A nonrecognition transaction other than a transaction involving Code Sec. 168(i)(7), Code Sec. 1031, Code Sec. 1033, a technical termination of a partnership, or the anti-abuse rule (Reg. §1.168(i)-1(e)(3)(iii)(B)).

COMMENT. Under the temporary GAA regulations, virtually every disposition and retirement of an asset was a qualifying disposition for which an election to recognize gain or loss by reference to the asset's adjusted basis could be made.

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:

1. The GAA terminates;
2. 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

3. The recognition and character of the gain or loss are determined under applicable provisions of the Code, except that the amount of gain subject to ordinary income depreciation recapture under Code Secs. 1245 and 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 (Reg. §1.168(i)-1 (e)(3)(ii)).

EXAMPLE. In 2016, EFG sells the remaining 800 calculators in the GAA for $35,000 (see the EFG example above). EFG elects the optional termination method. As a result, the account terminates and gain or loss is determined for the account. Depreciation for 2016 is $5,760 ($60,000 × 19.20% third-year table percentage × 50% to reflect half-year convention). On the date of disposition, the adjusted depreciable basis of the account is $23,040 (unadjusted depreciable basis of $60,000 less total depreciation of $36,960). Thus, in 2016, EFG recognizes gain of $11,960 (amount realized of $35,000 less the adjusted depreciable basis of $23,040). The gain of $11,960 is subject to Code Sec. 1245 to the extent of the depreciation allowed or allowable for the account (plus the expensed cost for assets in the account if any amount had been expensed) less the amounts previously recognized as ordinary income ($36,960 + $0 – $10,000 = $26,960). As a result, the entire gain of $11,960 is subject to Code Sec. 1245 (Reg. §1.168(i)-1(e)(3)(ii)(B), Ex. 1).

Demolitions of Building in GAA. If a building is placed in a single asset GAA and it is later demolished, the final regulations allow a taxpayer to continue to depreciate the building by not electing to terminate the account (1.168(i)-1(e)(3)(i)). Note, however, that a taxpayer may not place a building (or any other asset) in a GAA if it is acquired and disposed of (e.g., demolished) in the same tax year (Reg. §1.168(i)-1(c)(1)(i)).

It is unclear whether the anti-abuse rule of Reg. §1.168(i)-(e)(3)(vii) may apply in certain situations. That regulation provides that an asset is treated as removed from a GAA if a taxpayer enters into a transaction with a principal purpose of achieving a tax benefit or result that would not be available outside of the GAA.

The anti-abuse rule does not prevent a taxpayer from placing an asset in a GAA in order to avoid recognition of gain upon its bone fide disposition in order to take advantage of an expiring net operating loss (Reg. 1.168(i)-1(e)(3)(vii)(B)(2)).

Identifying Asset Disposed of from Multi-Item GAA. The final regulations allow the following methods to 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 IRS. The LIFO method is not permitted (Reg. §1.168(i)-1(j)). The original regulations do not provide these rules.

GAA ELECTION PROCEDURE

A taxpayer may make an irrevocable election to include assets in an MACRS 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 (Reg. §1.168(i)-(1)(l)). 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, which simply require a taxpayer to check a box on the form (line 18) 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.

A taxpayer may make a late election to set up a GAA for an asset placed in service in a tax year beginning before January 1, 2012 by filing an accounting method change for a tax year beginning on or after January 1, 2012 and before January 1, 2014. Late qualifying disposition elections are also allowed (Change 180). Since the deadline for filing an accounting method change is the extended due date of the tax return for the year of change, the deadline for make a late GAA election or a late qualifying disposition election has generally expired.

COMPLIANCE NOTE. A taxpayer may not make a late GAA election for an asset which it does not own at the beginning of the tax year of the election.

EFFECTIVE DATE

The final MACRS regulations, including Reg. §1.168(i)-1 relating to GAAs, apply to tax years beginning on or after January 1, 2014. A taxpayer may apply Reg. §1.168(i)-1 to tax years beginning on or after January 1, 2012, and before January 1, 2014 (Reg. §1.168(i)-1(m)).

A taxpayer may apply the temporary or proposed GAA regulations to a tax year beginning on or after January 1, 2012 and before January 1, 2014 but is not required to do so. At this point in time, taxpayers would generally only file accounting method changes to apply the final regulations to such tax years assuming the filing deadline for making the change has not expired.

ACCOUNTING METHOD CHANGES

A change to comply with the election to recognize gain or loss upon the disposition of the last asset in a GAA or the election to recognize gain or loss upon a qualifying disposition is not a change in accounting method. However, all other changes to comply with Proposed Reg. §1.168(i)-1 for depreciable assets placed in service in a tax year ending on or after December 30, 2003, are accounting method changes Reg. §1.168(i)-1(m)(5)). See the general discussion of accounting method changes later in this ebook for the significance of the December 30, 2003 date.

> **COMMENT.** Changes in accounting method to comply with the final GAA regulations are provided in Rev. Proc. 2014-54, as discussed below.

Overview

For taxpayers changing to an accounting method permitted or required under the final repair regulations, automatic change of accounting method procedures are provided in Rev. Proc. 2014-16, which modifies and supersedes Rev. Proc. 2012-19, effective January 24, 2014. Rev. Proc. 2014-16 also applies to change to a method in the temporary repair regulations for a tax year beginning on or after January 1, 2012 and before January 1, 2014.

Rev. Proc. 2014-54 modifies Rev. Proc. 2014-17 to provide accounting method procedures to comply with the final MACRS disposition regulations (Reg. §1.168(i)-8) and GAA regulations (Reg. §1.168(i)-1), effective for changes filed on or after September 18, 2014. Except for Reg. §1.168(i)-7 (dealing with item and multiple asset accounts), taxpayers, prior to the issuance of Rev. Proc. 2014-54, could change accounting methods to comply with the final regulations only by filing under the advance consent procedure (Rev. Proc. 97-27, 1997-1 CB 680) and paying a $7,000 fee. Taxpayers that filed under the advance consent procedure may convert to a feeless automatic consent request under Rev. Proc. 2014-54 if the advance consent request is pending with the national office (i.e., no letter ruling accepting or denying the request has been issued) (Rev. Proc. 2014-54, Section 5).

Rev. Proc. 2014-17 also provides automatic accounting method change procedures for complying with the proposed MACRS regulations dealing with general asset accounts (Proposed Reg. §1.168(i)-1) and dispositions (Proposed Reg. §1.168(i)-8) and the finalized MACRS regulation dealing with item and pool accounts (Reg. §1.168(i)-7). Rev. Proc. 2014-17 modifies and supersedes Rev. Proc. 2012-20, effective February 28, 2014.

PLANNING TIP. At this time, taxpayers would not ordinarily want to apply the temporary repair regulations or the temporary or proposed MACRS regulations to a 2012 or 2013 tax year. Instead, the final regulations would be applied. Moreover, since the filing deadline for making an accounting method change is the extended due date of the return for the year of change, the deadline for making an accounting method change has expired for all 2012 tax years and the 2013 calendar year. The deadline for some 2013 fiscal-year taxpayers may remain open as of publication of this e-book in December 2014.

Note that is it not necessary to apply the final or temporary repair regulations or the final, proposed, or temporary MACRS regulations to a tax year beginning on or after January 1, 2012 and before January 1, 2014.

CAUTION! Commentators have warned that filing a 2014 tax return that is not in compliance with the final repair and MACRS regulations may be a violation of Circular 230, which governs practice before the IRS. Section 10.34 of Circular 230 allows the IRS to censure, suspend, or disbar a practitioner who willfully, recklessly, or through gross negligence signs a tax return that the practitioner knows or should know contains a position that lacks a reasonable basis.

Amended Return Option for MACRS Regulations. The final 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 proposed and final MACRS regulations for some or all of such assets as a change that is not a change in accounting method. This means that no Form 3115 is filed and 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 open tax year, starting with the placed-in-service tax year. The amended return option will usually provide better results if a positive (unfavorable) adjustment would result from filing a Form 3115 (Rev. Proc. 2014-54, Section 3.01).

COMMENT. 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 may file amended returns for open years to claim the depreciation properly allowable in each open year.

12. Repair Regs: Changes Allowed Under Rev. Proc. 2014-16

IN GENERAL

The changes under the final repair regulations that are covered by Rev. Proc. 2014-16 are listed in the table at the end of this e-book.

These changes are added by Rev. Proc. 2014-16 to the Appendix of Rev. Proc. 2011-14 (new Appendix Section 10.11). Rev. Proc. 2011-14 provides general rules relating to all types of automatic consents and lists each specific type of allowable automatic consent change in its Appendix.

> **COMMENT.** Note that some of the changes described in the table consolidate a number of different specific types of changes. For example, change 184, relating to changes from capitalizing to deducting and vice versa, include most types of changes that are described in Reg. §1.263(a)-3. Thus, for example, a taxpayer changing to the safe harbor for routine maintenance costs files under change 184 because this method is described in subsection (i) of Reg. §1.263(a)-3. As explained below, the regulatory authority for the particular change must be cited in the statement required by Form 3115.

Change 184 under Rev. Proc. 2014-16 consolidates changes from capitalizing to deducting and from deducting to capitalizing. Under Rev. Proc. 2012-19 these were separate changes and, therefore, taxpayers could file in one year (e.g., for 2012 or 2013) a beneficial change from capitalizing to deducting and delay filing a change from deducting to capitalizing until 2014. By consolidating these changes, Rev. Proc. 2014-16 signals that the IRS expects taxpayers to take into account both favorable and unfavorable changes on the same Form 3115.

> **CAUTION!** Under Rev. Proc. 2012-19, the change to the routine maintenance safe harbor was assigned its own accounting number (change 171) but Rev. Proc. 2014-16 includes this change in the more

general category described in change 184. The routine maintenance safe harbor still remains an accounting method. On the other hand, the de minimis safe harbor is an accounting method under the temporary regulations (change 169) but is an elective safe harbor under the final regulations for which no accounting method change is filed.

ELECTIONS THAT ARE NOT METHOD CHANGES

The final repair regulations include the following annual elections that are not accounting method changes. In general, these elections must be made by the extended due date of the return for the tax year that the election applies.

- Election to capitalize and depreciate rotable, temporary, or standby emergency spare parts (Reg. §1.162-3(d));
- De minimis safe harbor election (Reg. §1.263(a)-1(f));
- Election to capitalize employee compensation and overhead costs (Reg. §1.263(a)-2(f)(2)(iv)(B));
- Safe harbor election for small taxpayers to deduct building expenses (Reg. §1.263(a)-3(h)); and
- Election to capitalize repair and maintenance costs in accordance with book treatment (Reg. §1.263(a)-3(n)) (Appendix Section 10.11(1)(b) of Rev. Proc. 2011-14, as added by Rev. Proc. 2014-16, specifically excludes these elections as accounting method changes).

Since the final regulations were only issued on September 19, 2013, some taxpayers had already filed 2012 returns and certain 2013 returns without making these elections. As explained earlier, the IRS granted transitional relief (now expired) to such a taxpayer to make a retroactive election. The relief applied to tax years beginning on or after January 1, 2012 and ending on or before September 19, 2013.

SPECIAL RULES FOR COMPLETING FORM 3115

The detailed description of the taxpayer's present and proposed accounting methods required by line 15 of Form 3115 should include a citation to the specific portion of the repair regulations that describes the method to which the taxpayer is changing. For example, a taxpayer adopting the safe harbor for routine maintenance under the final regulations should cite Reg. §1.263(a)-3(i) (change 184). Similarly, if a taxpayer is filing a change under the final regulations to capitalize amounts previously deducted as a

repair expense that are actually betterment, restoration, or adaptions costs, Reg. §1.263(a)-3(j), (k), or (i), respectively, should be cited (change 184).

In another common situation, a taxpayer may need to change its definition of a unit of property for personal property and/or buildings either as a separate change on Form 3115 (change 184 (final regulations)) or on the same Form 3115 with a change from deducting to capitalizing improvement costs (or vice versa) (also change 184). The Form 3115 must include a detailed description of the unit of property under the present system and under the proposed change, including a citation to the portion of final Reg. §1.263(e)-3(e) under which the unit of property is permitted (Appendix Section 10.11(4) of Rev. Proc. 2011-14, as added by Rev. Proc. 2014-16).

STREAMLINED FORM 3115 FILINGS

Rev. Proc. 2014-16 provides "reduced filing requirements for small taxpayers." A small taxpayer is a taxpayer with average annual gross receipts of $10 million or less during the preceding three tax years. The reduced filing requirements only exempt filers from completing certain lines of Form 3115 and do not affect the detailed computation of any required Code Sec. 481(a) adjustment.

CONCURRENT CHANGES ON SAME FORM 3115

A taxpayer that wants to make two or more changes described in new section 10.11 of the Appendix to Rev. Proc. 2011-14, as added by Rev. Proc. 2014-16, should file a single Form 3115 for all the changes and list all of the appropriate designated automatic changes on Part I line 1 of Form 3115. The taxpayer must attach to the single Form 3115 the information required by Part II line 12 (relating to a detailed statement relating to the item changed, the present method, and proposed method) and Part IV line 25 (relating to a separate Code Sec. 481(a) computation for each method change). An explanation must be attached for any other line(s) on the single Form 3115 where the answer is different for any of the concurrent changes.

COMPLIANCE NOTE. As originally published by the IRS, Rev. Proc. 2014-16 provided that a single Form 3115 should be filed when one or more changes in method of accounting are made for the same identified unit of property or the same identified building structure or building system. However, filing a separate Form 3115 for each unit of property (e.g., each machine) could result in a taxpayer filing hundreds of Form 3115s.

CONCURRENT CHANGE TO COMPLY WITH UNICAP

A taxpayer that wants to make a change to a UNICAP method described in any portion of the Appendix of Rev. Proc. 2011-14, along with one or more changes relating to the repair regulations that are described in Section 10.11 of the Appendix of Rev. Proc. 2011-14, as added by Rev. Proc. 2014-16, should file all changes on the same Form 3115 (Appendix Section 10.11(5)(b) of Rev. Proc. 2011-14, as added by Section 3.01 of Rev. Proc. 2014-16).

Rev. Proc. 2014-16 adds new Section 11.09 to the Appendix of Rev. Proc. 2011-14, to create an automatic procedure that allows a taxpayer to change to a reasonable allocation method within the meaning of Reg. §1.263A-1(f)(4), other than a method specifically described in Reg. §1.263A-1(f)(2) or (3) to properly allocate direct and indirect costs among self-constructed assets produced during the year.

> **COMMENT.** This change previously had to be filed under the advance consent procedure. Many amounts under the repair regulations must be allocated as direct or indirect costs to property produced by the taxpayer or acquired for resale. This new automatic change will enable taxpayers who are not properly allocating costs under the UNICAP rules to file concurrently with the related repair regulation change.

SCOPE LIMITATIONS WAIVED

The scope limitations of Section 4.02 of Rev. Proc. 2011-14 do not apply for a change made under Rev. Proc. 2014-16 for any tax year beginning before January 1, 2015. Primarily, the scope limitations prevent a taxpayer who is under audit or who has filed an accounting method change in the past five years from using the automatic change of accounting method procedures for the same method change. Thus, for example, the same change may be filed under Rev. Proc. 2014-16 for the 2013 and 2014 tax years (e.g., to correct an error in the original change or apply the same change to additional assets).

The scope limitations are also waived for an accounting method change made to comply with the (UNICAP) rules and filed concurrently (i.e., on the same Form 3115) with a change of accounting method to comply with the final repair regulations.

Significantly, a taxpayer may now change to an accounting method under the repair regulations without first being required to come into compliance with the UNICAP rules. Rev. Proc. 2012-19 required taxpayers to comply

with the UNICAP rules in order to make accounting method changes under the repair regulations, but permitted the UNICAP accounting method changes to be made on the same Form 3115 as the related repair regulation change.

Taxpayers are still allowed (but no longer required) to make a change to a UNICAP method in the same tax year that a related change is made under the final or temporary repair regulations. Taxpayers making concurrent changes should file a single Form 3115. Section 6.02(1)(b)(ii) of Rev. Proc. 2011-14 provides guidance for filing a single Form 3115 that includes two or more changes.

> **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 2014 as taxpayers file the necessary accounting method changes to come into compliance with the repair regulations. 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) COMPUTATIONS

A change to comply with the final repair regulations and the final MACRS regulations is a change in accounting method and requires a Code Sec. 481(a) adjustment that is not applied on a cut-off basis, unless the effective date of the provision is for amounts paid or incurred in tax years beginning on or after January 1, 2014 (or optionally on or after January 1, 2012).

Most provisions in the final regulations are effective for tax years beginning on or after January 1, 2014 (or optionally on or after January 1, 2012), and require the computation of a cumulative section 481(a) adjustment that effectively makes each such provision retroactive.

> **COMMENT.** The IRS refers to the cut-off adjustment as a "modified Code Sec. 481(a) adjustment" in Rev. Proc. 2014-16. However, this e-book will refer to a modified Code Sec. 481(a) as a cut-off adustment. If a cut-off method applies, a taxpayer continues to use its existing accounting method for amounts paid or incurred before the applicable cut-off date, and changes its accounting method for amounts paid or incurred on or after the cut-off date.

Taxpayers may compute a section 481(a) adjustment using the statistical sampling technique described in Rev. Proc. 2011-42 (IRB 2011-37, 318) for any accounting method change in the repair regulations that is not applied on a cut-off basis. 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 decreases taxable income and is taken into account in a single tax year. Positive adjustments increase taxable income and are accounted for over four tax years.

A taxpayer must calculate a Code Sec. 481(a) adjustment in the manner provided in sections 5.03 and 5.04 of Rev. Proc. 2011-14.

Cut-off Methods. For paid-or-incurred method changes made under the final repair regulations, the Code Sec. 481(a) adjustment needs to take into account only amounts paid or incurred in tax years beginning on or after January 1, 2014. Consequently no Code Sec. 481(a) adjustment is required if a paid-or-incurred method is adopted under the final regulations in 2014 by a calendar year taxpayer. However, if the paid-or-incurred method is adopted in a later tax year, for example 2015, then a Code Sec. 481(a) adjustment will take into accounts amounts that were paid or incurred in 2014 prior to the tax year of the change (Appendix Section 10.11(6) (b)(i) of Rev. Proc. 2011-14, as added by Rev. Proc. 2012-16).

> **PLANNING TIP.** A taxpayer has the option of computing the cut-off Code Sec. 481(a) adjustment under the final repair regulations by taking into account amounts paid or incurred in tax years beginning on or after January 1, 2012, even if the change is made for a tax year beginning on or after January 1, 2014. A taxpayer will benefit by selecting the January 1, 2012 cut-off date to compute a Code Sec. 481(a) adjustment if the adjustment is negative (taxpayer favorable) (Appendix Section 10.11(6) (b) of Rev. Proc. 2011-14, as added by Rev. Proc. 2012-16).

Paid-or-Incurred Methods Subject to Cut-Off Adjustment. The following are paid-or-incurred methods under the final repair regulations that require computation of a Code Sec. 481(a) adjustment on a cut-off basis using the tax year beginning on January 1, 2012, or January 1, 2014, as the beginning of the cut-off period:

1. Any method relating to materials and supplies, other than the optional method for rotable spare parts. These are any method described in Reg. §1.162-3 including:
   a. A change to deducting non-incidental materials and supplies when used or consumed (change 186),
   b. A change to deducting incidental materials and supplies when paid or incurred (change 187), or
   c. A change to deducting non-incidental rotable and temporary spare parts when disposed of (change 188);
2. A change to deducting certain costs for investigating or pursuing the acquisition of real property (whether or which) (Reg. §1.263(a)-2(f)(2)(iii) (change 193);
3. A change to deducting amounts for employee compensation and overhead costs as amounts that do not facilitate the acquisition of real or personal property (Reg.§1.263(a)-2(f)(2)(iv)) (change 193);
4. A change to capitalize inherently facilitative amounts allocable to real or personal property even if the property is not eventually acquired (Reg. §1.263(a)-2(f)(3)(ii) (change 192);
5. Optional regulatory method (Reg. §1.263(a)-3(m)) (change 185);
6. A change by a producer to capitalize under Code Sec. 263A direct material costs, such as the cost of materials and supplies (Reg. §1.263A-1(e)(2)(i)(A)); and
7. A change to capitalized indirect material costs such as materials and supplies that must be capitalized under Code Sec. 263A to the extent they are properly allocable to property produced by the taxpayer or property acquired for resale (Reg. §1.263A-1(e)(3)(ii)(E)).

FORM 3115 FILING DEADLINE

A taxpayer changing a method of accounting under the final repair regulations pursuant to Rev. Proc. 2014-16 must file a signed copy of its completed Form 3115 with the IRS in Ogden, Utah no earlier than the first day of the year of change, and no later than the date the taxpayer files the original Form 3115 with its federal income tax return for the year of change (Appendix Section 10.11(7) of Rev. Proc. 2011-14, as added by Rev. Proc. 2014-16). The original Form 3115 is filed with the timely filed (including extensions) income tax return for the year of the change (Form 3115 instructions). The Ogden filing is in lieu of filing a copy with the national office.

IMPACT. Since the filing deadline for changing an accounting method for the 2012 tax year has expired, the final and temporary repair regulations can no longer be adopted in the 2012 tax year by filing a Form 3115 with a 2012 tax return. For example, a calendar year taxpayer that wanted to change an accounting method under the final regulations for the 2012 tax year needed to file Form 3115 by the extended due date of the 2012 income tax return (e.g., September 15 or October 15, 2013). The filing deadline for making an accounting method change for the 2013 tax year has also expired for most taxpayers. For example, a fiscal-year taxpayer with a fiscal year beginning on December 1, 2013 and ending on November 30, 2014, however, could have until the extended due date of the 2013/2014 fiscal-year return (e.g., February 15 of 2015) to file an accounting method change for the 2013 tax year.

PLANNING TIP. Filing an accounting method change to a method provided in the final repair or MACRS regulations will provide "audit protection" for tax years prior to the effective date of the final regulations. Thus, even for cut-off methods that do not require a Code Sec. 481(a) adjustment, it is important to file the change so as to prevent the IRS from auditing open tax years and disallowing prior deductions etc., that are inconsistent with the regulations.

13. MACRS Regs: Changes Allowed Under Rev. Proc. 2014-54

IN GENERAL

Rev. Proc. 2014-54, modified Rev. Proc. 2014-17 to provide automatic accounting method changes to comply with the final MACRS general asset account and disposition regulations adopted by T.D. 9689 (8/14/2014) (Reg.§1.168(i)-1 and Reg.§1.168(i)-8). Prior to modification, Rev. Proc. 2014-17 only provided accounting method changes to comply for a tax year beginning on or after January 1, 2012 and before January 1, 2014 with the proposed MACRS GAA and disposition regulations as well of the final MACRS regulations dealing with item and multiple asset accounts (Reg.§1.18(i)-7). In addition, Rev. Proc. 2017-17 provided accounting method changes to comply with the temporary MACRS GAA, disposition, and item and multiple asset account regulations for a tax year beginning on or after January 1, 2012 and before January 1, 2014.

This discussion will focus on compliance with the final MACRS regulations for the 2014 tax year since the deadline for applying the final, proposed or temporary regulations for a tax year beginning in 2012 or 2013 tax year has generally expired except for certain taxpayers with a 2013 fiscal year. Such a fiscal year taxpayers would want to apply the final regulations to their 2013 fiscal year except in extraordinary circumstances.

> **COMMENT.** This portion of the discussion will generally refer only to Rev. Proc. 2014-54 even though, technically, the changes described are made pursuant to Rev. Proc. 2014-17, as modified by Rev. Proc. 2014-54.

Rev. Proc. 2012-20 provided automatic change of accounting method procedures to comply with the temporary regulations for changes filed before February 28, 2014. Rev. Proc. 2012-20 was modified and superseded by Rev. Proc. 2014-17, effective February 28, 2014.

COMMENT. The accounting method changes described in Rev. Proc. 2014-16 for the repair regulations and Rev. Proc. 2014-54 (relating to the MACRS regulations) are modifications or additions to the Appendix of Rev. Proc. 2011-14 which provides a comprehensive listing of nearly all automatic changes allowed by the IRS. Rev. Proc. 2011-14 provides general guidelines for automatic accounting method changes and these guidelines apply except to the extent the guidelines for a particular change described in the Appendix modifies them.

STREAMLINED FORM 3115 FILINGS

As in the case of Rev. Proc. 2014-16, certain accounting method changes described in Rev. Proc. 2014-17 provide small taxpayers with simplified rules for completing Form 3115. However, this does not excuse these taxpayers from computing required Code Sec. 481(a) adjustments.

FORM 3115 FILING DEADLINE

The filing deadlines discussed above for Rev. Proc. 2014-16 also apply to changes made under Rev. Proc. 2014-54. Thus, a signed copy of Form 3115 must be filed with the Ogden Utah office (in lieu of the national office copy) no sooner than the first day of the tax year of change and no later than the date the original Form 3115 is filed with the income tax return for the year of change. The original Form 3115 must be filed with the income tax return for the year of change no later than the extended due date for the income tax return.

UNIFORM CAPITALIZATION RULES

A taxpayer is not required to file changes to comply with the UNICAP rules prior to filing a change under Rev. Proc. 2014-54. However, in specified circumstances, a taxpayer is allowed to file a UNICAP change and a change under Rev. Proc. 2014-54 on the same Form 3115.

SCOPE LIMITATIONS WAIVED

The accounting method changes described in Rev. Proc. 2014-54 are generally not subject to the scope limitations of section 4.02 of Rev. Proc. 2011-14 for changes filed for tax years beginning on or after January 1, 2012 and before January 1, 2015.

SIGNIFICANT REV. PROC. 2014-54 METHOD CHANGES

For a limited period of time taxpayers will have the opportunity make late partial disposition elections for partial asset dispositions that took place in prior years by filing Form 3115 (change 196). This accounting method change must also be filed by taxpayers who applied the disposition rules of the temporary regulations and want to preserve previously claimed retirement losses on structural components of buildings and components of assets other than buildings, whether or not the building or asset was in a GAA. Taxpayers generally claimed such losses under the temporary regulations by filing an accounting method change pursuant to Rev. Proc. 2012-20.

LATE PARTIAL DISPOSITION ELECTIONS FOR DISPOSITIONS IN PRE-2012 TAX YEARS

A late partial disposition election may be made for dispositions of structural components (or components of assets other than buildings) that occurred in tax years beginning before January 1, 2012 by filing an accounting method change (change 196). In certain cases, previously discussed, a late election may also be filed through an accounting method change for dispositions in a tax year that began on or after January 1, 2012 and ended on or before September 19, 2013 (also change 196).

An accounting method change to make a late partial disposition election for pre-2012 dispositions under the final regulations (change 196) must be filed in a tax year that begins on or after January 1, 2012 and before January 1, 2015 by the extended due date of the income tax return. Since the filing deadlines for the 2012 tax year and, in most cases, the 2013 tax year have ended, the late election must be filed for no later than for the 2014 tax year.

In effect, taxpayers now have a one year opportunity to file an accounting method change to claim retirement losses on components of previously retired assets, such as structural components of building, even if the loss was not claimed by filing an accounting method change under the temporary regulations. A taxpayer must continue to depreciate the basis of any previously retired component for which a late partial disposition election is not made. It is not necessary to make this election for all prior partial dispositions.

CAUTION! A taxpayer may not make a late partial disposition election unless the taxpayer owns the asset of which the disposed of portion was a part at the beginning of the year of change. For example, a taxpayer may not make a late partial disposition election for a replaced roof of a building that is no longer owned.

RETIREMENT LOSSES ON ASSETS OUTSIDE OF GAA IF TEMP REGS WERE APPLIED

If a taxpayer filed an accounting method change under the temporary regulations to define a building and its structural components as separate assets in order to claim a retirement loss on the retirement of one or more a structural components, the taxpayer is required to file an accounting method change to redefine the building and the structural components as a single asset. If a taxpayer does not file a concurrent accounting method change to make a late partial disposition election with respect to the previously claimed retirement losses, then the previously claimed retirement losses will be "recaptured" as a Code Sec. 481(a) adjustment as part of the otherwise required asset definition change.

EXAMPLE. ABC placed a building in service in 2000 and replaced the roof in 2010. In 2012 it filed an accounting method change under the temporary regulations to define the building as an asset and each structural component of the building as a separate asset for disposition purposes. In addition, a concurrent accounting method change was made to claim a retirement loss on the replaced roof. In 2014, ABC must file an accounting method change to redefine the asset as the building including its structural components and to make a late partial disposition election to preserve the prior retirement loss (change 196). The Code Sec. 481(a) adjustment is $0 if the late election is made. If the late election is not made, ABC must file an accounting method change to redefine the asset as the building and structural components as a single asset (change 205 for buildings) and the retirement loss (less depreciation that would have been allowed on the retired roof) must be reported as a Code Sec. 481 adjustment (Section 6.33(8)(b), Example (2), of the Appendix of Rev. Proc. 2011-14, as added by Rev. Proc. 2014-17 and modified by Rev. Proc. 2014-54.).

COMPLIANCE NOTE. Where a taxpayer filed an accounting method change to define a portion of a component of property other than

a building as an asset under the temporary regulations in order to claim a retirement loss, the taxpayer must either change the definition of the asset and make a late partial disposition to preserve the loss by filing change 196 or change the definition of the asset and recapture the loss through a Code Sec. 481(a) adjustment by filing change 206 (for section 1245 property).

A taxpayer that files a change to make a late partial disposition election to preserve a loss claimed under the temporary regulations (change 196) does not file a separate change to redefine the asset. The redefinition is part of this change and is not filed separately under change 205 (for buildings) or 206 (for property other than buildings).

GAA REVOCATIONS

Some taxpayers previously made a late GAA election for a building (or other asset) placed in service in a tax year beginning before January 1, 2012 by filing an accounting method change (Change 180). This change was often accompanied by a change to make a late GAA qualifying disposition election to claim a loss on a prior retirement of a structural component (also change 180).

Due to changes to the temporary regulations by the final and proposed regulations discussed above, such a taxpayer should revoke the GAA election and the qualifying disposition election(s) (Change 197) and make a concurrent late partial disposition election on the same Form 3115 (Change 196) in order to preserve the loss deductions and the ability to deduct future losses on the retirement of structural components.

Similarly, timely GAA elections and qualifying disposition elections that were made for buildings placed in service during the 2012 and 2013 tax years may be revoked by filing change 197. However, even if the revocation is made the ability to preserve losses claimed on structural components retired in the 2012 or 2013 tax year by previously making a timely qualifying disposition election allowed under the temporary GAA regulations is limited to tax years beginning on or after January 1, 2012 and ending on or before September 19, 2013 (change 196).

COMMENT. The GAA revocation is not available to a taxpayer that made a timely (non-retroactive) GAA election for an asset placed in service in a tax year beginning in 2011. This is an apparent oversight insofar as it is possible that some fiscal-year taxpayers may have made a 2011 tax-year election in reliance on the temporary regulations.

COMPLIANCE NOTE. The deadline to file an accounting method change to make a late partial disposition election for dispositions that occurred in tax years beginning before January 1, 2012, was extended one year by Rev. Proc. 2014-54 and now must be filed no later than for a tax year beginning before January 1, 2015 (e.g., no later than for the 2014 tax year for a calendar year taxpayer).

A taxpayer that made a retroactive GAA election (or a timely 2012 or 2013 GAA election) and fails to revoke the election by filing an accounting method change (change 197) is required to file an accounting method change to treat the building and its structural components as a single asset (change 207 for assets remaining in a GAA) and "recapture," through a Code Sec. 481(a) adjustment, any retirement losses previously claimed by making a qualifying disposition election (as defined in the temporary regulations) with respect to retired structural components.

EXAMPLE. ABC filed an accounting method change for 2012 to make a retroactive GAA election for a building placed in service in 2000 and a qualifying disposition election with respect to a roof that was replaced in 2010 (Change 180). A $10,000 retirement loss was claimed. If the taxpayer does not file an accounting method change for 2014 to revoke the GAA election (change 197), the taxpayer is required to file an accounting method change for 2014 to redefine the building and its structural components as a single asset (change 207)) and must compute a Code Sec. 481(a) adjustment equal to the retirement loss less any depreciation that could have been claimed on the retired roof prior to the year of change if the retirement loss had not been claimed (Section 6.40(7)(c), Example of Section 6.40 of Rev. Proc. 2011-14, as added by Rev. Proc. 2014-54.

EXAMPLE. ABC filed an accounting method change to make a retroactive GAA election in 2012 for a building placed in service in 2000. An accounting method change was also filed to make a late qualifying disposition election for 2012 to claim a retirement loss on the undepreciated basis of the roof of a building which was replaced in 2010. In 2014 ABC files and accounting method change to revoke the GAA election (change 197) but does not file a concurrent change to make a late partial disposition election with respect to the roof (change 196). ABC must file an accounting method change to treat the building and its structural components as a single asset (change 205 for buildings not in a GAA) and include in income, as

a section 481(a) adjustment, the retirement loss previously claimed less depreciation that could have been claimed on the replaced roof in 2012 and 2013 if the retirement loss had not been claimed (Section 6.34(8)(c), Example 3 of Section 6.34 of Rev. Proc. 2011-14, as modifed by Rev. Proc. 2014-54). If a late partial disposition election is made concurrently with the GAA revocation (change 196) no Code Sec. 481(a) adjustment is required and it is not necessary to file change 205 in order to redefine the asset. The redefinition is considered part of change 196.

Generally, a retroactive GAA election is discussed only in the context of buildings. However, some taxpayers may have made retroactive GAA elections to place a group of section 1245 assets (e.g., vehicles) in a GAA account and made a qualifying disposition election to claim a loss upon the sale or retirement of a particular asset. Since a sale or and retirement of an entire asset is not a qualifying disposition under the final regulations, taxpayers will need to revoke these GAA elections to preserve the loss (change 197) and change their method of accounting to recognizing a loss upon the disposition of an asset under the rules that apply to assets outside of a GAA (change 206, described in Appendix Section 6.39(4)(i)). Upon revocation it is not necessary to file an accounting method change to make a partial disposition election (changer 196) to preserve the loss since gain or loss is recognized upon the retirement or sale of an entire asset that is not in a GAA.

EXAMPLE. ABC files an accounting method change to make a retroactive GAA election for its 2012 tax year for three trucks originally placed in service in 2011. ABC sells one of the trucks in 2012 and makes a timely qualifying disposition election to claim an $800 loss. If ABC files an accounting method change to revoke its 2012 GAA election (change 197) and a concurrent change to, recognize the loss on the retired truck under the non-GAA disposition rules of Reg. §1.168(i)-8, (change 206, described in Appendix Section 6.39(4)(i)) and place the two remaining trucks in separate item accounts or in a multiple asset account, the loss is not recaptured as a section 481(a) adjustment. If the GAA election is not revoked, ABC should file an accounting method change no later than for its 2014 tax year to reflect the requirement of the final GAA regulations that the entire proceeds from the sale be included in income and that depreciation continue on the disposed truck (Section 6.34(8)(b), Example 2 of Section 6.34 of Rev. Proc. 2011-14, as modified by Rev. Proc. 2014-54).

14. Tables of Method Changes

Rev. Proc. 2014-16 – Accounting Method Changes Under Final Repair Regs

Change No.	Appendix section of Rev. Proc. 2011-14	General Topic	Specific Purpose	Section 481(a) Adjustment	Statistical Sampling	Related Regulation
184	10.11(3)(a)(v) or (vi)	Deducting Repair and Maintenance Costs	A change to deducting amounts paid or incurred for repair and maintenance or a change to capitalizing amounts paid or incurred for improvements to tangible property and, if depreciable, to depreciating such property under section 167 or section 168. Includes a change, if any, in the method of identifying the unit of property, or in the case of a building, identifying the building structure or building systems for the purpose of making this change.	YES	YES	Reg. §1.162-4, Reg. §1.263(a)-3
185	10.11(3)(a)(xi)	Regulated Taxpayers	Change to regulatory accounting method	Cut-Off	NO	Reg. §1.263(a)-3(m)
186	10.11(3)(a)(i)	Materials and Supplies	Change to deducting non-incidental materials and supplies when used or consumed.	Cut-Off	NO	Reg. §1.162-3(a)(1), Reg. §1.162-3(c)(1)
187	10.11(3)(a)(ii)	Materials and Supplies	Change to deducting incidental materials and supplies when paid or incurred	Cut-Off	NO	Reg. §1.162-3(a)(2), Reg. §1.162-3(c)(1)
188	10.11(3)(a)(iii)	Rotable Spare Parts	Change to deducting non-incidental rotable and temporary spare parts when disposed of	Cut-Off	NO	Reg. §1.162-3(a)(3), Reg. §1.162-3(c)(2)
189	10.11(3)(a)(iv)	Rotable Spare Parts	Change to optional method for rotable and temporary spare parts	YES	YES	Reg. §1.162-3(e)
190	10.11(3)(a)(vii)	Dealers—Property Sales	Change to deduct commissions and other transaction costs that facilitate the sale of property	YES	YES	Reg. §1.263(a)-1(e)(2)
191	10.11(3)(a)(viii)	Non-Dealers—Property Sales	Change to capitalize commissions and other costs that facilitate the sale of property	YES	YES	Reg. §1.263(a)-1(e)(1)

Change No.	Appendix section of Rev. Proc. 2011-14	General Topic	Specific Purpose	Section 481(a) Adjustment	Statistical Sampling	Related Regulation
192	10.11(3)(a)(ix)	Acquisition and Production Costs	Change to capitalizing acquisition or production costs and, if depreciable, to depreciating such property under Code Secs. 167 or 168	YES	YES	Reg. §1.263(a)-2
192	10.11(3)(a)(ix)	Acquisition and Production Costs	A change to capitalize inherently facilitative amounts allocable to real or personal property even if the property is not eventually acquired	Cut-Off	NO	Reg. §1.263(a)-2(f)(3)(ii)
193	10.11(3)(a)(x)	Investigation Costs - Acquisition of Real Property	Change from capitalizing to deducting amounts incurred to investigate acquisition of real property	Cut-Off	NO	Reg. §1.263(a)-2(f)(2)(iii)

Rev. Proc. 2014-54

Change No.	Appendix section of Rev. Proc. 2011-14	General Topic	Specific Purpose	Section 481(a) Adjustment	Statistical Sampling	Related Regulation
180	6.32(1)(a)	Various late GAA elections	A late GAA election for one or more items of MACRS property placed in service in a tax year beginning before 2012.	Modified cut-off	NO	Reg. §1.168(i)-1
180	6.32(a)(iii)		A late election to recognize gain or loss upon the disposition of all of the assets, the last asset, or the last portion of the last asset in a GAA	YES	NO	Reg. §1.168(i)-1(e)(3)(ii)
180	6.32(a)(v)		A late election to recognize gain or loss upon the disposition of an item in a GAA in a qualifying disposition	YES	NO	Reg. §1.168(i)-1(e)(3)(iii)
196	6.33(1)(a)	Late partial disposition elections	A late partial disposition election under Reg.§1.168(i)-8(d)(2)(i) for the disposition of a portion of an asset that was disposed of in a tax year that began before January 1, 2012	YES	NO	Reg.§1.168(i)-8(d)(2)(i)
196	6.33(1)(a)		A late partial disposition election for a portion of an asset that was disposed of in a tax year beginning on or after January 1, 2012 and ending on or before July 19, 2013 where a taxpayer timely filed its original 2012 or 2013 return without making a timely partial disposition election for dispositions that occurred in the 2012 or pre-July 19, 2013 tax year	YES	NO	Reg.§1.168(i)-8(d)(2)(iv)(B)

Change No.	Appendix section of Rev. Proc. 2011-14	General Topic	Specific Purpose	Section 481(a) Adjustment	Statistical Sampling	Related Regulation
197	6.34(1)(a)(i)	GAA election revocations	Revoke a late GAA election previously made by filing an accounting method change for MACRS property that was placed in service in a tax year beginning before January 1, 2012	YES	NO	
197	6.34(1)(a)(ii)		Revoke a timely GAA election that was made for MACRS property placed in service in a tax year beginning on or after January 1, 2012, and before January 1, 2014	YES	NO	
198	6.35(1)(a)	Partial Disposition Election: Audits	Change to make a late partial disposition election if the taxpayer deducted the amount paid for the replacement of a portion of an asset as a repair, the taxpayer did not make a timely partial disposition election for the disposed portion of that asset, and the IRS later applies the rules in the repair regulations and disallows the taxpayer's repair deduction and instead capitalizes it	YES	NO	Reg. §1.168(i)-8(d)(2)(iii)
199	6.36(1)(a)-(c)	Leasehold Improvements	From improperly depreciating a leasehold improvement over the term of the lease (including renewals, if applicable) to depreciating the improvement over its assigned recovery period under Code Sec. 168, Code Sec. 167, or Code Sec. 197, as applicable	YES	NO	Reg. §1.167(a)-4
200	6.37(4)(a)(i)	GAA, Item and Multiple Asset Accounts: Permissible to Permissible Methods	Change from single item accounts to multiple asset accounts or vice versa	Modified cut-off	NO	Reg. §1.168(i)-7
200	6.37(4)(a)(ii) or (b)(i)		Asset grouping changes within a multiple asset or general asset account	Modified cut-off	NO	Reg. §1.168(i)-7(c); Reg. §1.168(i)-1(c)
200	6.37(4)(a)(iii)-(viii) or (b)(ii)-(vii)		Change in method of identifying asset disposed of from multiple asset account or general asset account	YES	NO	Reg. §1.168(i)-8(g)(1) or (2); Reg. §1.168(i)-1(j)(2)
200	6.37(4)(a)(ix)-(x) or (b)(viii)		Change in determining unadjusted depreciable basis of disposed asset or portion of disposed asset from one reasonable method to another reasonable method when impracticable to determine using taxpayer's records (for assets in item, multiple asset or general asset accounts)	YES	NO	Reg. §1.168(i)-8(f)(2) or (3);Reg. §1.168(i)-1(j)(3)

Change No.	Appendix section of Rev. Proc. 2011-14	General Topic	Specific Purpose	Section 481(a) Adjustment	Statistical Sampling	Related Regulation
205	6.38(4)(a)	Buildings not in a GAA: Impermissible to permissible method	Change to treating building, condo, coop, or addition or improvement, including structural components thereof, as appropriately defined asset for disposition purposes	YES	YES	Reg. §1.168(i)-8(c)(4)
205	6.38(4)(b) or (c)		Change to recognizing gain or loss on disposed building, condo, coop, addition or improvement, or portion thereof that is presently being depreciated	YES	YES	Reg. §1.168(i)-8(h)(1)
205	6.38(4)(d)		Change from improper to proper method of identifying particular building, condo, coop, addition or improvement disposed of from multiple asset account	YES	YES	Reg. §1.168(i)-8(g)(1) or (2)
205	6.38(4)(e) or (g)		Change from not using taxpayer's records to determine unadjusted depreciable basis of building, condo, cooper, or addition or improvement disposed of from a multiple asset account or a portion of such an asset disposed of from an item or multiple asset account when it is practicable to use taxpayer's records	YES	YES	Reg. §1.168(i)-8(f)(2) or (f)(3)
205	6.38(4)(f) or (h)		Change from impermissible to permissible method to determine unadjusted depreciable basis of building, condo, cooperative, or addition or improvement disposed of from a multiple asset account or a portion of such an asset disposed of from an item or multiple asset account when impracticable to use taxpayer's records (e.g., from consumer price index to producer price index)	YES	YES	Reg. §1.168(i)-8(f)(2) or (f)(3)
205	6.38(4)(i)		In the case of a taxpayer that revokes a GAA election (Change #197) and in a tax year prior to the revocation made a qualifying disposition election under the temporary regulations (including a late qualifying disposition election) to recognize gain or loss on a building, condo, coop, or addition or improvement under the temporary regulations, a change to recognizing gain or loss under the final regulations. Does not apply to disposition of portions of assets (e.g., structural components)	YES	YES	Reg. §1.168(i)-8

Change No.	Appendix section of Rev. Proc. 2011-14	General Topic	Specific Purpose	Section 481(a) Adjustment	Statistical Sampling	Related Regulation
206	6.39(4)(a)-(i)	Section 1245 property and land improvements not in a GAA: Impermissible to permissible method	These changes are identical to the #206 changes described above for buildings except that they apply to section 1245 property and land improvements	YES	YES	
207	6.40(4)(a)	General asset accounts: Impermissible method to permissible method	Change in determining asset disposed of from an inappropriately defined asset to an appropriately defined asset	YES	NO	Reg. §1.168(i)-1(e)(2)(viii)
207	6.40(4)(b)		Change in method of identifying which assets or portions of assets have been disposed of from a method not specified in §1.168(i)-1(j)(2) to a method specified in §1.168(i)-1(j)(2)	YES	NO	Reg. §1.168(i)-1(j)(2)
207	6.40(4)(c)		A change in the method of determining the unadjusted depreciable basis of a disposed asset or disposed portion of an asset in a GAA from a method not using the taxpayer's records to a method using the taxpayer's records when using the taxpayer's records is practicable	YES	NO	Reg. §1.168(i)-1(j)(3)
207	6.40(4)(d)		A change in the method of determining the unadjusted depreciable basis of the disposed portion of the asset from an unreasonable method (e.g., using the Consumer Price Index) to a reasonable method (e.g., using the Producer Price Index)		NO	Reg. §1.168(i)-1(j)(3)