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Section 6045B Reporting Triggers

Accounting for Tangible Property Expenditures

Consider Tax Credit Phase-Outs

DEDUCTING OR CAPITALIZING EXPENDITURES RELATED TO TANGIBLE PROPERTY

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New temporary regulations establish basic rules to determine whether an expenditure related to tangible personal property should be capitalized or expensed based on its effect on the improvement rather than its cost.

At the end of December 2011, the Treasury and the IRS promulgated temporary regulations (Temp. Regs.) principally dealing with the application of the expensing rules of Section 162 and the capitalization rules of Section 263 with respect to tangible personal property. The Temp. Regs. are generally effective for amounts paid or accrued after 1/1/12.

A change to conform to the Temp. Regs. will be a change in method of accounting under Section 446(e). In general, a taxpayer seeking a change in method of accounting to comply with the Temp. Regs. has to take into account an adjustment under Section 481(a). On 3/8/12, the Service published Rev. Procs. 2012-19[1] and 2012-20,[2] which provide procedures whereby a taxpayer may obtain automatic consent to change its method of accounting to that provided in the Temp. Regs. for a tax year beginning on or after 1/1/12. Taxpayers will undoubtedly be comparing the principles in the Temp. Regs. with prior rules, including the manner in which the prior rules were applied to them on audit, to determine the impact of any such change.

On 3/15/12, the IRS issued a memorandum to its staff providing direction to the field in examinations of the repair versus capitalization issue.[3] The memorandum instructed its staff to discontinue current exam activities and not commence activities with regard to this issue for tax years beginning before 1/1/12. For years beginning after 1/1/12 and before 1/1/14, the staff is advised to perform an audit risk assessment if the taxpayer has filed for a change in the method of accounting. If the taxpayer has not filed for a change and if the waiver period for filing for such a change is open, the staff is directed to allow the taxpayer to file for such a change. After 2014, normal exam procedures apply, but attention is to be directed to the Section 481(a) adjustment accompanying the change in method of accounting.

This article will focus mainly on the impact of the Temp. Regs. on residential real estate. Taxpayers and practitioners encouraged by many of the favorable rules included in the proposed regulations will be unhappy with changes in the Temp. Regs. that limit or remove those rules. Nevertheless, the Temp. Regs. have adopted rules that are more liberal than those applied previously. This suggests that a substantial number of taxpayers will opt for an accounting method change to the rules of the

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Temp. Regs. and a corresponding Section 481(a) adjustment.

The Temp. Regs. clarify the scope of Reg 1.162-4. Prior regulations limited repairs to those that were "incidental" and that did not materially add value to property. Thus, they focused on the impact on value of the cost of the improvement. The Temp. Regs. essentially focus on the impact of the expenditure on the unit of property rather than the amount expended. They retain the rule from the 2008 proposed regulations and provide that a taxpayer is permitted to deduct amounts paid to repair and maintain tangible property unless those amounts are required to be capitalized under another Code provision. The Temp. Regs. would generally require taxpayers to capitalize all costs paid or incurred in selling, acquiring, producing, or improving tangible property, including costs of facilitating an acquisition of such property.

Taxpayers and their representatives should be alert to the plethora of past decisions that do not reflect the principles set out in the Temp. Regs., such as those prior cases that rely on the *Indopco* principle in reaching the conclusion that an expenditure must be capitalized. For example, in *Hill*,[4] the Tax Court based its decision on the *Indopco* principle that "An item is a capital expenditure which may not be deducted in full currently if it has a useful life substantially beyond the taxable year." Under the Temp. Regs., the fact that a repair may have a useful life of more than one year standing alone is not a basis for requiring capitalization. It would seem that cases decided by the application of principles inconsistent with those set forth in the Temp. Regs. should have little relevance to deciding future controversies unless, as some suspect, the decisions in this area are based on a visceral reaction to the facts followed by the generation of a legal rationale to support the conclusion. However, to the extent that the supplemental information to the Temp. Regs. cites cases with conclusions based on the application of principles that are not consistent with those in the Temp. Regs., they contribute to continued uncertainty as to the value of prior decisions in reaching a current conclusion.

The Temp. Regs. introduce a set of new basic principles for determining whether the facts indicate that an expenditure is to be capitalized or expensed in terms of the impact of the expenditure on the improvement rather than its cost. It would seem that these rules would apply in making any Section 481(a) adjustment. The Temp. Regs. deal separately with the principles to be applied in the decision-making process in the following subjects:

1. The term "unit of property," which plays a determinative role in concluding whether a cost is incurred to acquire or produce property or is an additional cost relating to a larger item of property or is merely a repair of an existing unit of property.
2. Costs of acquiring or producing tangible property.
3. Costs of improving property.
4. The treatment of items classified as materials and supplies.
5. Selling costs.

Unit of property

The term "unit of property" (UOP) performs a significant and varied role under the Temp. Regs. For example, a taxpayer must separately capitalize acquisition and production costs for each UOP, the term "improvement" includes a *betterment* of a UOP, and the term "materials and supplies" generally includes only items that are neither UOPs nor acquired as parts of a UOP. If a taxpayer replaces an item used in its business, the replacement cost is the new item's original basis if the item is a UOP, but the cost may be deductible as a repair expense if the item is a minor part of a UOP.

The new UOP rules apply only for purposes of:

- Section 263(a), generally barring current deductions for new buildings or permanent improvements made to increase the value of any property or estate.
- Temp. Reg. 1.263(a)-1T, explaining which types of expenses must be capitalized; Temp. Reg. 1.263(a)-2T, dealing with amounts paid to acquire or produce tangible property; Temp. Reg. 1.263(a)-3T, dealing with improvements to tangible property; and Temp. Reg. 1.162-3T, explaining how to handle materials and supplies.[5]

Thus, for example, treating an asset as part of a larger UOP for capitalization purposes does not affect how that asset is treated for depreciation purposes. As explained below, how-

[1] 2012-14 IRB 689.
[2] 2012-14 IRB 700.
[3] Large Business and International Division Directive LB&I-4-0312-004.
[4] TCM 1983-112.
[5] Temp. Reg. 1.263(a)-3T(e)(1).

ever, the reverse is not true: the way a taxpayer treats an asset for depreciation purposes may affect how the asset is treated for capitalization purposes.

Generally, under the Temp. Regs., as under the prior proposed regulations, UOPs are identified using a "functional interdependence standard," under which all "components that are functionally interdependent comprise a single unit of property" and components 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." For example, for a railroad, each locomotive is a unit of property. On the other hand, if a law firm purchases a laptop computer and a printer for use by one of its employees, the laptop and printer are separate units of property because the computer can be placed in service without the printer.

An improvement to a UOP is part of the improved property, not a UOP separate from the improved property, even though the improvements are treated as separate assets for depreciation purposes. For example, an improvement to a building that the taxpayer owns is considered part of the building and is not a UOP separate from the building, even though the taxpayer computes depreciation separately for the building and improvement.

The Temp. Regs. supplement the functional interdependence standard with special rules for buildings, "plant property," and "network assets." The rules for these assets derive from the Treasury's conclusion that, for some types of property, the functional interdependence test often results in a very expansive unit of property, and it is inappropriate to use such a large unit of property for making a determination regarding improvements.

Also, if a unit of depreciable property, as identified by the foregoing rules, includes components that the taxpayer depreciates differently from other components in the unit for financial accounting, regulatory accounting, or tax purposes, the unit is subdivided so that all components of each UOP are depreciated alike for all of these purposes.

UOP for buildings. In general, each building and its structural components are one UOP—"the building." Amounts are treated as paid for an improvement to a building if they improve the building structure or any designated building system. The identification of designated building systems as separate from the building is new in the Temp. Regs.

A building structure consists of a building and its structural components as defined at Reg. 1.48-1(e) (unless the component is a building system).[6] Under Reg. 1.48-1(e)(2), the term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings, such as paneling or tiling; windows and doors; and other components relating to the operation or maintenance of a building. Thus, aside from the segregation of building systems, the definition of building structure is similar to that used previously in the proposed regulations and, in general, as liberal, or more liberal, than that assumed by the IRS in its audit practice

The IRS believes that, in applying this standard, if a business taxpayer replaces the entire roof, the expense is treated as an improvement to the single UOP consisting of the building. Similarly, if the taxpayer makes a betterment to a building system, such as an improvement to the heating, ventilation, and air conditioning (HVAC) system, the expense also constitutes an improvement to the building UOP.[7] This is at odds with the conclusion reached by many taxpayers as reflected in the IRS comments contained in the supplementary information, on the basis of the proposed regulations, that major work performed on buildings did not result in an improvement because the work affected only a small portion of the unit of property.

This new term "building system" consists of nine structural components. Each of them (including their sub-components) is a building system that is separate from the building structure, and to which the improvement rules must be separately applied.

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1. 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 items such as sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, and alarm control panels).
7. Security systems that protect the building and its occupants (including items such as locks, security cameras, motion detectors, security lighting, and alarm systems).
8. Gas distribution systems (including associated pipes and equipment used to distribute gas to and from the property line and between buildings or permanent structures).
9. Other structural components identified in published IRS guidance that are not part of the building structure and are specifically designated as building systems.[8]

Example: ABX, Inc., owns a building that it uses in its retail business. The building has two elevator banks in different locations and each elevator bank contains three elevators. ABX must treat the building and its structural components as a single UOP, and all of the elevators, including all their components, comprise a building system. Thus, if ABX pays for an improvement (i.e., a betterment) to the elevator system, it must treat the expense as an improvement to the building.[9]

Notwithstanding the more limited definition of building structure resulting from the separate classification of designated building systems, the definition of a building and its structural components as one unit of property would seem to be a significant liberalization of the base against which the expenditure on the property is to be compared to determine whether the expenditure results in an improvement. Moreover, it is significantly broader than the comparatives used for that purpose in the audit experience of many taxpayers. However, the Temp. Regs. no longer provide favorable bright line guidance as to where the line is to be drawn between capitalization and deduction.

An improvement to a building, other than a leasehold improvement, is considered part of the building and is not a unit of property separate from the building. A leasehold improvement made by a lessee is a separate unit of property if it is Section 1250 property.

Temp. Reg. 1.263(a)-3T(g) also provides special rules applying the UOP principle to condominiums and condos, and to lessors and lessees, basically treating each interest as a separate UOP. Thus, if a taxpayer "owns or occupies an individual unit in a building with multiple units," the taxpayer's UOP is that unit. For example, if a taxpayer owns a condominium apartment, the taxpayer's ownership rights in the condominium are a unit of property. This rule should have no impact on the owners of a residential property who renovate apartments with regulated rents in order to justify market based rents. However, it could have a negative impact on those renting unsold condominium units who renovate them to achieve higher market rentals because the apartment rather than the building is the UOP.

Plant property. "Plant property" is a set of "functionally interdependent machinery or equipment," other than network assets, that the taxpayer uses in performing an "industrial process," such as manufacturing, electric generation, warehousing, distribution, automated materials handling, or "other similar activities." Under the functional interdependence standard, the entire set would be a unit of property. Under the special rule for plant property, each component or group of components within the set "that performs a discrete and major function or operation" is a unit of property.

Assume a company owns a building, and many items of manufacturing equipment that are housed in the building are not structural components of the building and function as an integrated manufacturing system. The building and its structural components are one unit of

[6] Temp. Reg. 1.263(a)-3T(e)(2)(ii).
[7] TD 9564, 12/23/11.
[8] Temp. Reg. 1.263(a)-3T(e)(2)(ii).
[9] Temp. Reg. 1.263(a)-3T(e)(6), Example 2.
[10] Temp. Reg. 1.168(i)-8T(b).
[11] Temp. Reg. 1.263(a)-3T(e)(5)(i)).
[12] Temp. Reg. 1.263(a)-3T(e)(6), Example 16.

property. The manufacturing equipment would be one unit of property under the functional interdependence test, but because the equipment is plant property, this unit is divided into smaller units, each containing components or groups of components that perform a discrete and major function. Finally, under a depreciation consistency rule described below, the company must remove from each unit any component that is depreciated using a recovery period or depreciation method different from the period and method used for the remainder of the unit of property.

Network assets. "Network assets" are railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines used by a taxpayer in its business, whether as owner or lessee. Power, telephone, and cable lines include trunk and feeder lines, pole lines, and buried conduit. Structural components of buildings and "separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels," are not network assets.

The Temp. Regs. do not define "unit of property" in the context of network assets because the Treasury "generally" believes that the unit of property rules for these assets "should be addressed on an industry-by-industry basis in Internal Revenue Bulletin guidance."

Impact of UOP rules. The downside to the new UOP rule for buildings is that improvements to a building system must be capitalized as part of the building, while under the proposed regulations the taxpayer may have currently deducted the cost (for example, the replacement of an electrical system). However, as TD 9564 explains, the upside is that the taxpayer will be able to recognize a loss on the disposition of a structural component of a building before it sells the entire building, so that it will not have to continue to depreciate amounts allocable to structural components that are no longer in service. Thus, under the Temp Regs., a taxpayer will not have to capitalize and depreciate simultaneously amounts paid for both the removed and the replacement properties.

As noted above, the new Temp. Regs. specifically permit taxpayers to treat the retirement of a structural component as a disposition.[10] The IRS acknowledges that it may be difficult for taxpayers to determine the amount of the adjusted basis of the property that is allocable to a retired component. This difficulty may be particularly acute when a taxpayer has capitalized a number of improvements as part of renovations. In TD 9564, the IRS asks for comments on computational methodologies or safe harbors that a taxpayer may use to simplify the adjusted basis determination. However, in audit controversies, a taxpayer will now have to be prepared not only to contest the expense or capitalization issue but, if the expenditure must be capitalized, the relevant amount of unrecovered basis of the removed structural components.

Characterization of asset for depreciation purposes overrides UOP rules. Notwithstanding the above UOP rules, a component (or a group of components) of a UOP must be treated as a separate UOP if one of the following is true when the UOP is initially placed in service by the taxpayer:

1. The taxpayer properly treated the component as being within a different class of property under Section 168(e) for MACRS depreciation purposes than the class of the UOP of which the component is a part.
2. The taxpayer properly depreciated the component using a different depreciation method than the depreciation method of the UOP of which the component is a part.[11]

Example: XYZ, Inc. transports freight throughout the U.S., and owns a fleet of truck tractors and trailers, each of which is made up of various components, including tires. XYZ buys a truck tractor with all of its components, including tires (which have an average useful life to XYZ of more than one year). When XYZ put the tractor in service, it treated the tractor tires as a separate asset for depreciation purposes. It properly treated the tractor (excluding the cost of the tires) as three-year property and the tractor tires as five-year property. Under the general UOP rules, XYZ must treat the tractor, including its tires, as a single UOP because the tractor and the tires are functionally interdependent (that is, the placing in service of the tires is dependent on the placing in service of the tractor). However, because XYZ properly treated the tires as being within a different class of property for depreciation purposes, it must treat the tractor and tires as separate UOPs for capitalization purposes.[12]

Similarly, notwithstanding the general UOP rules, in any tax year after a UOP is initially placed in service by the taxpayer, if the taxpayer or the IRS changes the treatment of that property (or any portion if it) to a proper MACRS class or a proper depreciation method (for example, as a result of a cost segregation study or a change in the use of the property), the taxpayer must change the UOP determination for

that property (or portion of it) to be consistent with the change in treatment for depreciation purposes. Thus, for example, if part of a UOP is properly reclassified to a MACRS class different from the MACRS class of the UOP of which it was previously treated as a part, the reclassified portion of the property is treated as a separate UOP for capitalization purposes.

Example: In 2012, ABC acquired and placed in service a building and parking lot for use in its retail operations. It capitalized the cost of the building and the parking lot and began depreciating them as nonresidential real property over 39 years. In 2014, ABC completes a cost segregation study under which it properly determines that the parking lot qualifies as 15-year property for depreciation purposes, and changes its method of accounting to use a 15-year recovery period and the 150% declining balance method of depreciation for the parking lot. Beginning in 2014, ABC must treat the parking lot as a UOP separate from the building.[13]

Some assets located in a building are not structural components and do not belong in one of the building systems categories. For example, for depreciation purposes, assets such as decorative canopies, awnings, millwork, and facades have been held to be short-lived Section 1245 property (i.e., personal property) rather long-lived Section 1250 property. Presumably, these types of assets also will be treated as separate UOPs for capitalization purposes. Similarly, that part of the electrical wiring, plumbing, or fire protection equipment directly associated with nonbuilding equipment (such as an oven) has been held to be a short-lived, non-building asset. Presumably, these types of assets will be capitalized to the non-building asset with which they are directly associated.

Costs of acquiring or producing tangible property

A taxpayer must capitalize amounts paid or incurred to "facilitate" the acquisition or production of a UOP. An amount is paid to facilitate an acquisition if it "is paid in the process of investigating or otherwise pursuing the acquisition." A cost is deemed to facilitate an acquisition if it is "inherently facilitative." Inherently facilitative costs include costs of (1) transporting acquired property (e.g., shipping fees and moving costs), (2) appraising or otherwise determining the value or price of property, (3) "negotiating the terms or structure of the acquisition," (4) "tax advice on the acquisition," (5) "application fees, bidding costs, or similar expenses," (6) "preparing and reviewing the documents that effectuate the acquisition of the property," including a bid, offer, sales contract, or purchase agreement, (7) "examining and evaluating" title to the property, (8) "obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees," (9) conveying the property to the taxpayer, "including sales and transfer taxes, and title registration costs," (10) "finders' fees or brokers' commissions, including amounts...contingent on the successful closing of the acquisition," (11) "architectural, geological, engineering, environmental or inspection services pertaining to particular properties," and (12) services of a qualified intermediary or other facilitator of a like kind exchange under Section 1031.

All amounts paid to facilitate the acquisition or production of tangible property are capital expenditures. Facilitative costs allocable to property that the taxpayer acquires or produces are included in the property's original basis. Inherently facilitative amounts allocable to an item of property are capital expenditures, rather than deductible expenses, related to the property, even if the taxpayer ultimately does not acquire or produce the property. A taxpayer may allocate inherently facilitative costs among "separate and distinct properties" that it considers, regardless of the taxpayer's ultimate intent or plan, capitalizing allocable transaction costs to each property, including properties not acquired, and recovering costs allocable to each property as appropriate under the applicable provision of the Code (e.g., Section 165, 167, or 168). Thus, if a taxpayer decides to acquire a tract of land, on which it will construct a building for use in its business, and it considers two tracts for this purpose, it may allocate its inherently facilitative costs among the two tracts, add the costs allocated to the tract acquired to the original basis of that tract, and deduct costs allocated to the tract not acquired as a loss when it ends its consideration of this tract.

Unless inherently facilitative, costs of investigating or otherwise pursuing an acquisition of real property are deemed not to facilitate an acquisition if they relate "to activities performed in the process of determining whether to acquire real property and which real property to

[13] Temp. Reg. 1.263(a)-3T(e)(6), Example 18.

acquire."(i.e. the whether or which determination). This rule covers "certain pre-decisional investigative activities, such as marketing studies, that are not...inherently facilitative."

Example: A chain retailer, in the course of considering the feasibility of opening a new store in a particular city, hires (1) a consulting firm to study the city, perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations on areas that the retailer should consider and (2) an appraiser to determine a fair offering price for each of two sites, one of which the retailer later acquires as the location of a new store and one of which it excludes from further consideration. The retailer is not required to capitalize the consultant's fees because the consultant's work is not inherently facilitative and the fees are incurred in the process of determining whether to acquire real property and which property to acquire. It must capitalize the appraiser's fees because appraisal costs are inherently facilitative. It must include the costs of appraising the property acquired in that property's original basis, and it is allowed a deduction for the appraisal costs allocable to the property not acquired when it decides not to pursue this property further.

Generally, taxpayers are not required to capitalize employee compensation or overhead as costs of facilitating property acquisitions.

Costs of defending or perfecting title. Amounts paid or incurred to "defend or perfect title to" property are considered costs of acquiring or producing the property. For example, if an owner of real property hires an attorney to contest an eminent domain proceeding seeking a portion of the property for use as a roadway, the owner must capitalize the attorney's fees because they are incurred to defend title to the property. In contrast, if a municipality adopts an ordinance prohibiting continued operation of a sand and stone quarry within its jurisdiction, costs incurred by the owner and operator of the quarry in a successful suit to invalidate the municipal ordinance are costs of preserving the quarry business, not defending the owner's title to the property, and are thus not capitalized into the adjusted basis of the quarry.

De minimis rule. Under the de minimis rule of Temp. Reg. 263(a)-2T(g), a taxpayer generally is not required to capitalize costs of acquiring or producing a UOP (including a UOP that is real property), including costs of facilitating the property's acquisition or production, if it satisfies all of the following requirements:

1. The taxpayer has an "applicable financial statement" that includes a certified audited financial statement accompanied by an independent CPA's report and used for credit reporting purposes, for the tax year during which it pays or incurs the costs.
2. At the beginning of the year, it has "written accounting procedures treating as an expense for nontax purposes the amounts paid for property costing less than a certain dollar amount."
3. The taxpayer treats the costs of the particular property as an expense on the applicable financial statement in accordance with these procedures.
4. The aggregate of amounts paid and not capitalized under the de minimis rule are less than or equal to the greater of (a) 0.1% of the taxpayer's gross receipts for the tax year as determined for federal income tax purposes, or (b) 2% of the taxpayer's total depreciation and amortization expense for the tax year.

Costs of improving property

Central to the distinction between treating an expenditure as capital or an expense is the general rule that "a taxpayer must capitalize the aggregate of related amounts paid to improve a UOP, whether the improvements are made by the taxpayer or by a third party, and whether the taxpayer is an owner or lessee of the property." A UOP is improved if costs paid or incurred for activities performed after the taxpayer places the property in service (1) result in a betterment to the UOP, (2) restore the UOP, or (3) adapt the UOP to a new or different use. This should be contrasted with a provision in the regulations prior to promulgation of the Temp. Regs. providing for capitalization of expenditures that materially increase the value of property, substantially prolong its useful life, or adapt it to a new or different use.

Costs of repairs and maintenance to tangible property are deductible as paid or incurred unless they are costs of improving property. In other words, a cost is deductible as a repair or maintenance expense if it is incurred with respect to property in an activity in which the taxpayer does not acquire or produce a UOP or make an improvement to a UOP. However, routine maintenance does not include amounts paid to replace a component of a UOP when the taxpayer has (1) properly deducted a loss for that component (other than a casualty loss under Reg. 1.165-7) or (2) properly taken into account the adjusted basis of the component in

realizing gain or loss resulting from the sale or exchange of the component; to repair damage to a UOP for which the taxpayer has taken a basis adjustment as a result of a casualty loss or casualty event under Section 165; and to return a UOP to its former ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use.[14]

Capitalizing betterment costs. An important area of distinction between repair and capitalization is the requirement under the Temp Regs. that taxpayers must capitalize betterment costs and can deduct costs that do not result in a betterment. Betterment is a new term that consists of amounts paid for one of the following:

- To ameliorate a material condition or defect that either existed before the taxpayer acquired the UOP or arose during its production, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production.
- A material addition (including a physical enlargement, expansion, or extension) to the UOP.
- A material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the UOP or the output of the UOP.[15]

The question of whether an expense results in a betterment is determined based on the facts and circumstances, including but not limited to: the purpose of the expense; the physical nature of the work performed; the effect of the expense on the UOP; and the taxpayer's treatment of the expense on its applicable financial statement (AFS). If a part cannot be replaced with the same part (e.g., due to technological advancements or product enhancements), replacing it with an improved but comparable part does not, by itself, result in a betterment.[16] Thus, it is the impact of the expense rather than simply its magnitude that dictates the result. Focusing on the impact of the expenditure rather than its cost is an important feature of the Temp. Regs.

A condition is not a betterment, however, if it was not considered to be a defect requiring amelioration when the taxpayer acquired the property.

Example: Miranda owns a building that was constructed years ago with insulation containing asbestos, when the health dangers of asbestos were not widely known. After Miranda has owned the building for several years, she discovers that the insulation has begun to deteriorate in some areas and could pose a health risk to her employees. She removes the asbestos-containing insulation and replaces it with new insulation, not containing asbestos, that is safer for people working in the building but is not more efficient or effective than the old insulation. Removal and replacement of the insulation is not a betterment because (1) the asbestos, although later determined to be unsafe, was not considered an inherent and material defect when Miranda bought the property and (2) the removal and replacement does not materially add to the building or materially increase its capacity, productivity, efficiency, strength, or quality.

This approach would seem particularly suited to deducting as expenses expenditures made to older buildings. The following example illustrates a betterment resulting from a material increase in capacity, productivity, efficiency, strength, quality, or output.

Example: X Corp., which owns a factory building with a storage area on the second floor, replaces columns and girders supporting the second floor to allow it to store supplies weighing 50% more than the previous load-carrying capacity of the storage area. X must capitalize its costs for the columns and girders as an improvement because they materially increase the building's capacity. In contrast, if the owner of a building used in its trade or business removes a drop-ceiling and repaints the original ceiling, this work does not add to the building's capacity or otherwise materially increase its productivity, efficiency, strength, quality, or output, and the owner is not required to capitalize costs of the work as a betterment.

Facts relevant to whether a cost yields a betterment include "the physical nature of the work performed and the effect of the expenditure on the UOP."

Example: X Corp. purchases for use in its manufacturing operations a used machine with a class life of ten years that will require manufacturer-recommended scheduled maintenance every three years, including inspection of parts for defects and replacement of minor items such as springs, bearings, and seals with comparable and commercially available and

[14] Temp. Reg. 1.263(a)-3T(g)(3).

[15] Temp. Reg. 1.263(a)-3T(h).

[16] Temp. Reg. 1.263(a)-3T(h)(3).

reasonable replacement parts. Although the machine is fully operational when X purchases it, it is then nearing the end of a three-year scheduled maintenance period. X performs this maintenance about one month after it purchases the machine. Although most of the costs of this maintenance do not qualify as routine maintenance, "considering the facts and circumstances," including "the purpose and minor nature of the work performed," the scheduled maintenance does not "ameliorate a material condition or defect" and thus is not a betterment.

Capitalization of costs on the taxpayer's applicable financial statement is a factor favoring capitalization for tax purposes, but this factor is not determinative.

Example: A company operating a nationwide chain of retail stores periodically changes the layout and appearance of each store in order to remain competitive; these changes include reconfigurations to better display merchandise and cosmetic alterations to keep the store modern and attractive to customers. In its applicable financial statement, the company capitalizes the costs of these changes and writes them off over five years, the estimated period between the updates. Notwithstanding this financial accounting treatment, the company is not required to capitalize the costs for tax purposes because the updates do not materially increase the stores' capacity, productivity, efficiency, strength, quality, or output and are therefore not betterments. This is among the examples that indicate that cosmetic improvement to properties does not result in a betterment.

Expenditures required by a 'particular event.' If "a particular event necessitates an expenditure," whether the expenditure results in a betterment of a unit of property is determined by comparing the property's condition immediately after the expenditure with its state immediately before that event.

Example: A hotel building has unreinforced terra cotta and concrete parapets with overhanging cornices around its roof perimeter. Although the parapets and cornices are in good shape, the owner of the hotel replaces them with new ones made of glass-fiber-reinforced concrete, attached to the hotel with welded connections instead of wire supports, in order to comply with an ordinance, newly adopted by the city in which the hotel is located, raising standards for parapets and cornices to reduce the possibility of failure in an earthquake. The event necessitating the expenditure is the ordinance. Replacement of the parapets and cornices materially increases the structural soundness (strength) of the hotel building, as compared with its condition before the ordinance was adopted. The hotel's owner must therefore capitalize costs of the replacement as a betterment.

If the particular event is a storm, fire, or other casualty, the comparison is made to the property's condition before the casualty.

Example: A storm damages the roof of a small retail shop, destroying many of the wooden shingles with which the roof was constructed several years ago. Rather than attempting to repair the damaged portions of the roof, the shop's owner replaces the entire roof. The event necessitating the expenditure is the storm. If the new roof also consists of wooden shingles, the reroofing is not a betterment because it does not materially increase the building's output, capacity, productivity, efficiency, or strength compared with its condition before the storm. The result is the same if the new roof consists of "comparable asphalt shingles." In contrast, the reroofing is a betterment if the replacement shingles are "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." In the latter case, the reroofing materially increases the building's quality, compared with the building's condition before the storm.

Correcting normal wear and tear. If an expenditure is made "to correct the effects of normal wear and tear" to a UOP, whether it results in a betterment is determined by comparing the property's condition after the expenditure with its condition "after the last time the taxpayer corrected the effects of normal wear and tear," whether the prior correction was routine maintenance or an improvement. This rule applies to expenditures for "the amelioration of a condition or defect" that existed when the taxpayer acquired the property but resulting from normal wear and tear before the taxpayer's acquisition. Thus, the correction of normal wear and tear should be expensed and with the abandonment of the application of the plan of improvement principle to unrelated repair expenses, this should be the case without regard to other capitalized expenses.

If the taxpayer has not previously corrected the effects of normal wear and tear, the property's condition after the expenditure is com-

pared with its condition when the taxpayer placed it in service.

Example: A company in the business of providing assisted living services acquired a building for use in this business. Although the building functioned as an assisted living facility before and after the purchase, the company was aware at the time of purchase that the building did not meet its minimum standards. More two years following the purchase, while it continued to use the building as an assisted living facility, the company (1) replaced flooring materials, windows, bathroom tiling and fixtures, window treatments, furniture, and cabinets, (2) repaired or replaced roofs and heating and cooling systems, and (3) did other repairs and maintenance, including painting. The company capitalized the costs of this work on its applicable financial statements. For tax purposes, it must capitalize these costs as a betterment. The purpose of the expenditures, their effects on the building, and the treatment of the expenditures in the applicable financial statements all lead to the conclusion that the work ameliorated material conditions and defects existing when the company purchased the building and materially increased the building's quality over its condition when the company placed it in service. Costs of work done on the building and its structural components are therefore capitalized into the building's adjusted basis.

Restorations. A taxpayer must capitalize costs incurred "to restore a unit of property, including amounts paid in making good the exhaustion for which an allowance is or has been made." According to the Treasury, under Section 263(a)(2), which states that no deduction is allowed for amounts paid in restoring property or making good exhaustion thereof for which an allowance is or has been made, the taxpayer must also capitalize:

1. Replacement of a component of a UOP if "the taxpayer has properly deducted a loss for that component." For example, if a company abandons a nonfunctioning component of a unit of property and takes a loss deduction for the abandoned component's adjusted basis, it must capitalize the costs of replacing the component.
2. Replacement of a component of a unit of property if "the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component." For example, if a taxpayer decides to replace a component of a unit of property, sells the replaced component, and subtracts its adjusted basis for the component in determining gain or loss on the sale, it must capitalize the costs of replacing the component.
3. Repair of damage to a UOP for which "the taxpayer has properly taken a basis adjustment as a result of a casualty loss...or relating to a casualty event." For example, if a storm damages an office building, for which the owner has an adjusted basis of $500,000, and the owner deducts a casualty loss of $50,000 and properly reduces its basis for the building to $450,000, the owner must capitalize any costs that it incurs in repairing the damage. The owner must also capitalize repair costs if it receives insurance proceeds covering the loss and reduces its basis by the amount of the proceeds received, even though it is allowed no casualty loss deduction in this context.

The Temp. Regs. also identify three instances of restorations that require capitalization within a more literal meaning of the term:

1. Work that "returns the UOP to its ordinarily efficient operating condition" after "the property has deteriorated to a state of disrepair and is no longer functional for its intended use."
2. "Rebuilding of the UOP to a like-new condition after the end of its economic useful life." A UOP is rebuilt to like-new condition "if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any Federal regulatory guideline or the manufacturer's original specifications," and property's "economic useful life" is "the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or for the production of income." Economic useful life is determined with "reference to" the taxpayer's "experience with similar property taking into account present conditions and probable future developments." A cost is not required to be capitalized under this rule if it is paid or incurred during the property's MACRS recovery period.
3. "Replacement of a major component or a substantial structural part of the UOP."

Example: A railroad owns a fleet of freight cars, each of which has a MACRS recovery pe-

[17] Temp. Reg. 1.263(a)-3T(j).

[18] Temp. Reg. 1.263(a)-3T(j)(4), Example 1.

[19] Temp. Reg. 1.263(a)-3T(j)(4), Example 2.

[20] Temp. Reg. 1.263(a)-3T(f)(3)(i).

[21] *Id.*

riod of seven years and an economic useful life of 30 years. It rebuilds each car every eight to ten years, a process that includes (1) a complete disassembly, inspection, and reconditioning or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment, (2) modifications to upgrade components to the latest engineering standards, (3) replacing or sandblasting and repainting of the car's walls, (4) installing new wheels, and (5) restoring all other components. The rebuild restores the car to rebuilt condition under the manufacturer's specifications. Rule 2 does not require the railroad to capitalize the cost of any rebuild during the first 30 years that a car is in service, although capitalization could be required by other aspects of the regulations on improvements. However, rule 2 requires the railroad to capitalize the cost of any rebuild performed on a car after it has been in service for more than 30 years.

The examples in the Temp. Regs. illustrate how difficult it will be to apply these rules to everyday situations. Examples 13-15 of Temp. Reg 1.263(a)-3T(h)(4) previously discussed, involve a small retail shop that suffers storm damage to some of its roof shingles. Redoing the entire roof with wood shingles does not have to be capitalized as a betterment to the shop, and neither does redoing the entire roof with asphalt shingles if wood shingles became unavailable. However, redoing the entire roof with shingles made of a lightweight, composite material that is maintenance free, non-absorptive, has a 50-year life and a Class A fire rating, will have to be capitalized as a betterment to the shop.

In Examples 12-14 of Temp. Reg. 1.263(a)-3T(i)(5), a retailer's replacement of an entire roof (or a significant portion of it) to correct structural damage that led to a leak must be capitalized as a restoration expense. However, if a manufacturer replaced only the waterproof membrane portion of its factory's roof to solve a leakage problem, it would not have to capitalize the cost under Section 263 (but under Section 263A it may be a capitalized indirect cost that directly benefits or is incurred by reason of production activities).

Examples 11 and 12 of Temp. Reg. 1.263(a)-3T(h)(4) make it clear that the fact that work is undertaken to satisfy a regulatory requirement is not relevant in determining whether the amount is paid to improve a property or is a "repair." This is the same result prescribed by the courts before the Temp. Regs. were issued.

Capitalizing amounts to adapt property to a new or different use. Under this rule, the cost of adapting a UOP to a new or different use must be capitalized. In general, a "new or different use" means a situation in which the adaptation is not consistent with the taxpayer's intended ordinary use of the property when he or she placed it in service.17 (For example, the cost of converting a company's manufacturing facility into a showroom facility must be capitalized.[18]) However, if the owner of a building consisting of 20 retail spaces converts three spaces into one larger space for an existing tenant by knocking down walls, the cost of the conversion is not treated as a new or different use because the combination of spaces is consistent with the owner's intended, ordinary use of the building.19

Temp. Reg. 1.263(a)-3T(j)(4), Example 4, illustrates how closely a company will have to scrutinize its expenditures. It deals with a manufacturer that polluted its land, but then spends money on it before selling the land to a residential developer. The cost of remediating the land to make it suitable for residential use does not adapt it to a new and different use and does not have to be capitalized under Temp. Reg. 1.263(a)-3T(j), but the cost of regrading the land must be capitalized under that regulation, because it adapts the land to a use different from the one the company intended when it put the land in service.

Repairs undertaken contemporaneously with improvements. Under the judicially developed plan of rehabilitation doctrine, a taxpayer must capitalize otherwise deductible repair costs if they are incurred as part of a general plan of renovation or rehabilitation. The new Temp. Regs. modify this doctrine. They specifically provide that indirect costs made at the same time as an improvement, but that do not directly benefit or are not incurred by reason of the improvement, do not have to be capitalized under Section 263(a).[20] This rule is illustrated by an example in which a company takes a truck out of service to overhaul its chassis. During the overhaul, the truck's broken tail-lights are replaced and tears in the driver's seat are mended. These expenses are deductible as repairs. However, a taxpayer still must capitalize under Section 263A, all the direct costs of an improvement and all indirect costs (such as otherwise deductible repair or component removal costs) that directly benefit or are incurred by reason of an improvement.[21] Abandonment of a broadly asserted plan

of rehabilitation rule will require taxpayers to carefully examine costs that are not part of an improvement and allocate costs that qualify for expensing. This can be more difficult in building repair situations. For example, if a taxpayer must construct scaffolding in order to do roof repair work, but at the same time incurs capitalized costs with respect to the structure, is the cost of the scaffolding a repair cost if it would have been incurred if only repairs were made or is some allocation required?

Removal costs. The Temp. Regs. contemplate that costs of removing a component of a unit of property should be analyzed in the same manner as any other indirect cost incurred during an improvement to property. Thus, similar to the treatment of otherwise deductible repair and maintenance costs incurred during an improvement, the costs of removing a component of a unit of property must be capitalized if they directly benefit or are incurred by reason of an improvement to a unit of property.[22] As with other costs incurred during an improvement, a taxpayer may deduct the costs of removing a component if the taxpayer can demonstrate that such costs relate only to the disposition of the removed property and that the costs do not have the requisite relationship to any improvement.

In addition, the Temp. Regs. do not affect the holding of Rev. Rul. 2000-7 as it applies to the costs of removing an entire unit of property. Under Rev. Rul. 2000-7, a taxpayer is not required to capitalize the cost of removing a retired depreciable asset under Section 263(a) or Section 263A, even when the retirement and removal occurred in connection with the installation of a replacement asset. Historically, the costs of removing a depreciable asset generally have been allocable to the removed asset and, thus, generally have been deductible when the asset is retired.[23]

Because the costs of removing a retired asset typically relate to the depreciable asset being removed and are not allocable to the improvements, Temp. Reg. 1.263(a)-3T generally is not applicable to such removal costs. Moreover, the Temp. Regs. do not change the treatment of any amounts addressed under Section 280B, which governs amounts expended and losses sustained for the demolition of structures.

The continued viability of Rev. Rul. 2000-7 illustrates one of the problems in dealing with the Temp. Regs. Although the Temp. Regs. are generally effective in tax years beginning after 12/17/11, taxpayers and tax advisors will still have to determine the extent to which prior guidance continues to apply. This problem arises in other provisions of the Temp. Regs. as well.

Nonbuilding routine maintenance safe harbor. Under this new safe harbor, the cost of routine maintenance performed on a UOP that *is not a building or a structural component* is treated as not improving the UOP (and therefore is currently deductible). Routine maintenance refers to the recurring activities that a taxpayer expects to perform as a result of its use of the UOP to keep it in its ordinarily efficient operating condition. Examples include: inspection, cleaning, and testing; and the replacement of parts of the UOP with comparable and commercially available reasonable replacement parts. In general, amounts paid for routine maintenance also include routine maintenance performed on (and with regard to) rotable and temporary spare parts.[24]

The safe harbor applies only if, at the time a UOP is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life (under the Section 168 alternative depreciation rules) of the UOP.

Whether an expense is "routine maintenance" depends on factors such as the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statement (AFS), such as one required to be filed with the SEC.[25]

Routine maintenance for buildings. The Temp. Regs. withdraw the rule in the proposed regulations extending the routine maintenance safe harbor rule to buildings because buildings typically have a long class life and many remodeling projects arguably could be deducted under the routine maintenance safe harbor rule, regardless of the na-

[22] See Towanda Coke Corp. 95 TC 124 (1990) (holding that costs of removing piping damaged in a fire and installing new pipe were capital expenditures); Phillips Easton Supply Co., 20 TC 455 (1953) (holding that costs of removing a cement floor in a building and replacing it with a concrete floor were capital expenditures to improve the property); Rev. Rul. 2000-7, 2000-1 CB 712 (providing that the costs of removing a component of a depreciable asset are either capitalized or deducted based on whether the replacement of the component constitutes an improvement or a repair).

[23] See Regs. 1.165-3(b), 1.167(a)-l(c), and 1.167(a)-ll(d)(3)(x); Rev. Ruls. 74-455, 1974-2 CB 63 and 75-150, 1975-1 CB 73.

[24] Temp. Reg. 1.263(a)-3T(g)(1).

[25] Temp. Reg. 1.263(a)-3T(g)(2).

[26] Temp. Reg. 1.162-3T(a).

[27] Temp. Reg. 1.162-3T(c).

ture or extent of the work involved. The IRS and Treasury concluded that allowing a deduction for costs attributable to these types of projects is inconsistent with much of the case law addressing building improvements. The reason reflected in TD 9564 is as follows:

> Accordingly, the routine maintenance safe harbor is not appropriate for work performed on buildings. Rather, the proper analysis requires the application of the general rules for improvements, including the rules for determining whether the costs are incurred for a betterment or restoration to the building or the building systems, or to adapt the building or any of its systems to a new or different use. The temporary regulations revise the routine maintenance safe harbor to apply only to property other than buildings. In addition, the temporary regulations include new rules clarifying the application of the improvement standards to a building and provide new examples illustrating the application of these rules.

Amounts paid or incurred to acquire or produce a "unit of real or personal property," including leasehold improvements, land, land improvements, buildings, machinery, and equipment, furniture, and fixtures must be capitalized. Costs of acquiring or producing property include the invoice price, "transaction costs," and "costs for work performed prior to the date that the unit of property is placed in service by the taxpayer."

Example: Y Corp. purchases a building for use as a business office, but before placing the building in service, it repairs cement steps, shores up parts of the first and second floors, replaces electrical wiring, removes and replaces old plumbing, and paints the building, inside and out. Y must capitalize the costs of this work as part of its adjusted basis for the building.

Amounts required to be so 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." These amounts are recovered by depreciation, as cost of goods sold, or by "an adjustment to basis" when the taxpayer places the property in service or sells, uses, or otherwise disposes of it.

A de minimis rule, generally available only to taxpayers with audited financial statements, allows a taxpayer to expense costs of items acquired or produced for small amounts.

Materials and supplies

Current Reg 1.162-3, only a few sentences long, generally provides that charges for materials and supplies are deductible as expenses only in the amount actually consumed and used in operation during the year. The cost of incidental materials and supplies purchased during the year is deductible in the year purchased if no record of their consumption is kept and no physical inventory of them is taken at the beginning and end of the year. However, this method may be used only if it clearly reflects income.

Timing of deduction for materials and supplies. Under the new Temp Regs, the costs of buying or producing:

- *Non-incidental* materials and supplies are deductible in the tax year in which the materials and supplies are used or consumed in the taxpayer's operations.
- *Incidental* materials and supplies that are carried on hand, and for which no record of consumption is kept or physical inventories at the beginning and end of the year are not taken, generally are deductible in the tax year in which they are paid, provided taxable income is clearly reflected.[26]

Thus, the timing rules for materials and supplies generally are the same as under current regulations.

New definition of materials and supplies. The Temp. Regs. define the term "materials and supplies" as tangible property used or consumed in the taxpayer's business operations that is not inventory and that falls within *any* of the following categories:

1. It is a component acquired to maintain, repair, or improve a unit of tangible property (see below) owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property.
2. It consists of fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations.
3. It is a unit of property with an economic useful life (see below) of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations.
4. It is a unit of property with an acquisition cost or production cost (as determined under Section 263A) of $100 or less (or other amount identified in published guidance).
5. It is identified in published IRS guidance as materials and supplies eligible for the rules in Temp. Reg. 1.162-3T.[27]

The IRS says that the Temp. Regs. do not supersede, obsolete, or replace earlier revenue procedures to the extent they deem certain property to constitute materials and supplies under Reg 1.162-3. For example, Rev Proc

2002-12[28] allows a taxpayer to treat smallwares (a restaurant's glassware, flatware, etc.) as materials and supplies that are not incidental under Reg 1.162-3. The IRS says such property continues to qualify as materials and supplies under the Temp. Regs. because it is identified in published guidance as materials and supplies (category (5), above).[29]

This illustrates one of the difficulties in implementing the Temp Regs. Although they generally are effective in tax years beginning after 12/31/11, taxpayers and their advisors still will have to determine the extent to which prior guidance continues to apply. Also, taxpayers will have to determine the method they are required to apply by reason of the method of accounting they have been using. This problem surfaces in other parts of the Temp. Regs. as well.

Treating an asset as part of a larger UOP for capitalization purposes does not affect how that asset is treated for depreciation purposes.

Effective dates and changes in methods of accounting

The Temp. Regs. are generally effective for amounts paid or incurred (to acquire or produce property) in tax years beginning on or after 1/1/12. A change to conform to these regulations will be a change in method of accounting under Section 446(e). In general, a taxpayer seeking a change in method of accounting to comply with these temporary regulations must take into account an adjustment under Section 481(a). Rev. Procs. 2012-19 and 2012-20 provide a two-year period in which the taxpayer may obtain automatic consent for a tax year beginning on or after 1/1/12 to change to a method of accounting provided in the temporary regulations.

A Section 481(a) adjustment is imposed for a change in method of accounting to conform to the Temp. Regs. The supplemental information states that this approach, rather than the use of a cut-off date, is desirable because it provides for a uniform and consistent rule for all taxpayers and ultimately reduces the administrative burdens on taxpayers and the IRS in enforcing the requirements of Section 263(a). Although the IRS and the Treasury Department recognize that requiring a Section 481(a) adjustment may place a burden on taxpayers to calculate reasonable adjustments, they believe taxpayers have shown a willingness and ability to make these calculations in requesting method changes after the publication of the 2008 proposed regulations. In addition, taxpayers and the IRS routinely reach agreements on calculation methodologies and amounts. Moreover, they believe that by using a Section 481(a) adjustment to make the change, a taxpayer is put on the same method of accounting for all amounts or costs incurred both prior to and after the effective date of these regulations. Finally, requiring a Section 481(a) adjustment reduces the burden for taxpayers and the IRS during examinations that include years both before and after the effective date of these regulations because the parties will need to apply only the temporary regulations, and will not need to apply the rules in effect prior to the effective date of the Temp. Regs. It remains to be seen whether examinations will be more or less contentious when they involve changes to conform to the different standards of the Temp. Regs.

Determining Section 481(a) adjustments. As noted, the Section 481(a) adjustment will be required as a transition mechanism to offset any duplications or omissions resulting from the change in method of accounting. One important question that arises is how far back do the Temp. Regs. require one to look for affected transactions? With respect to depreciable buildings, this could mean a potential look-back period in calculating the Section 481(a) adjustment of up to 39 years. Even in the case of other types of property with shorter depreciation periods, the look-back period for calculating the Section 481(a) adjustment could nevertheless encompass many prior tax years. Because of the number of years at issue, there may be difficulty identifying records to substantiate any adjustment. This raises at least the following issues:

1. Will taxpayers be required to look back as much as 39 years into their past history of repair v. capital transactions to locate transactions that might be affected by the Temp. Regs.?
2. What measures is a taxpayer expected to undertake to identify the scope of a Section 481(a) adjustment? What obligation does a taxpayer have to review records and what are

[28] 2002-1 CB 374.

[29] Preamble to TD 9564.

[30] Section 6694(a).

[31] Section 6694(b).

the government's expectations regarding records review? What should a taxpayer do when records are incomplete or unavailable?

How should one approach the task of complying with the Temp. Regs.?

Where should a taxpayer look for affected transactions, and where might the IRS look if it audits the taxpayer for compliance with the Temp. Regs.? It would seem that the following would be relevant:

1. The taxpayer's fixed asset listing and deductible repair expenditure accounts.
2. Past Schedule M adjustments.
3. Repair v. capital transactions that were the subject of prior-year IRS examination adjustments or settlements, particularly if such adjustments or settlements appear in prior IRS 30-Day Letters or Appeals settlement documents.
4. Other transactions based on practitioners' experiences with Form 3115.

Consequences of non-compliance with regulations

The preparer penalty under Section 6694 imposes monetary penalties on tax return preparers who prepare returns resulting in underpayments of tax due to "unreasonable positions"[30] or due to willful or reckless conduct.[31] Historically, Circular 230 has imposed practice standards for the preparation of tax returns on CPAs, attorneys, and other professionals who practice before the IRS. It provides for sanctions to those who engage in "disreputable conduct," including misconduct in connection with the preparation of tax returns.

Amended section 10.34 of Circular 230 closely mirrors the civil penalty standards of Section 6694, including the requirement that positions on a return or claim for refund must always meet the minimum standard of reasonable basis. However, there are a few differences between IRC Section 6694 and section 10.34. While the application of a Section 6694 penalty depends on there being an understatement of tax resulting from the position in question, section 10.34 does not provide an exception to the potential application of a sanction "merely because there is a final determination that no understatement of liability for tax exists." Circular 230 also differs from Section 6694 in that a practitioner is subject to discipline under section 10.34(a) only when "willful, reckless, or grossly incompetent conduct" is determined (unlike Section 6694(a), under which an unintentional error that is not "willful, reckless, or grossly in-competent" may result in a penalty).

This raises the following questions:

1. What is the advisor's duty of diligence with respect to a taxpayer's compliance with the Temp. Regs. if the advisor is a tax return preparer for the taxpayer?
2. With respect to penalty exposure, is a taxpayer's diligence, or that of its advisor, in searching for capitalizable transactions, a function of the length of the look-back period that must be reviewed?
3. In evaluating the merits of a full examination of prior-year transactions as contrasted with adopting a less burdensome approach and accepting the risks on audit, how should the advisor weigh the concept of audit protection in relation to the regulations? For example, if omitted transactions affected by the regulations are detected by the IRS on audit, when will such omissions be viewed as an adjustment to the taxpayer's claimed Section 481(a) adjustment and when will the adjustment be considered outside of any method changes encompassed by the taxpayer's previously-filed Form 3115, thereby exposing the taxpayer to interest and potential penalties?

It is not clear how adjustments under Section 481(a) are to be made with respect to the change in the rules applicable when the taxpayer has disposed of a structure. For example, in the case of buildings, taxpayers have been required to continue to capitalize and depreciate the costs of a replaced structural component. (Thus, a taxpayer could not take a retirement loss on the disposition of a structural component of a building.) The Temp. Regs. revise the definition of dispositions so that a taxpayer now may treat the retirement of a structural component of a building as a disposition of property. Since the Temp. Reg. provision is elective, it may be that it is available only with respect to dispositions beginning in 2012 rather than on a look-back basis that would affect the Section 481(a) adjustment. However, the new disposition rule could be viewed as integral to the decision to adopt the Temp. Regs.

A similar issue exists with respect to repair expenses previously capitalized pursuant to the plan of rehabilitation principle. Should those expenditures now be considered expenses subject to Section 481(a)? ■