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Capitalization of Costs for Tangible Property

ABA SECTION OF TAXATION
Tax Accounting Committee
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I. General Rule

No deduction is allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate or any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion. Treas. Reg. § 1.263(a)-1(a).

II. Acquired or Produced Property

A. General Rules.

1. Capitalize amounts paid to acquire or produce tangible property having a useful life extending substantially beyond the end of the taxable year. Treas. Reg. § 1.263(a)-2(d)(1)(i).
2. Capitalize amounts paid to acquire tangible property for resale or to produce tangible property for sale. *Id.*
3. No change in Treas. Reg. § 1.162-3 rules governing treatment of materials and supplies. Treas. Reg. § 1.263(a)-2(c)(2).

B. 12 Month Rule.

1. General Rule. Amounts paid for acquisition or production of a unit of property with an economic useful life of 12 months or less are deductible. Treas. Reg. § 1.263(a)-2(d)(4)(i).

2. Exceptions.

a) Property produced for sale or acquired for resale;

b) Improvements;

c) Land;

d) Components of a unit of property; and

e) Taxpayer elects to capitalize (on a unit of property basis).
Treas. Reg. § 1.263(a)-2(d)(4)(iii), (v).

C. De Minimis Rule. The proposed regulations do not include a de minimis rule, but the preamble states that the absence of a rule is not intended to change current taxpayer favorable exam practices with respect to acquired property. In addition, the preamble describes a de minimis rule considered by IRS and Treasury that would permit deduction of the cost of acquired property up to the following amounts: (i) for taxpayers with an applicable financial statement (“AFS”) de minimis amount, the lesser of such amount or an unspecified dollar cap; and (ii) a lower unspecified dollar amount for taxpayers with no AFS. *See* 71 Fed. Reg. 48,590, 48,593-94 (2006).

D. Interaction with Section 461. An accrual basis taxpayer may not take a liability into account under section 263 before the liability is “incurred” under section 461. Treas. Reg. § 1.263(a)-2(d)(4)(ii).

E. Transaction costs.

1. Capitalize amounts paid to facilitate the acquisition of tangible property. Treas. Reg. § 1.263(a)-2(d)(3)(i).

2. Amounts paid to facilitate the acquisition of a trade or business are governed by the intangibles regulations. *Id.*; *see* Treas. Reg. § 1.263(a)-5.

3. Amounts paid in connection with property produced by the taxpayer or acquired for resale are governed by section 263A. Treas. Reg. § 1.263(a)-2(d)(3)(i).

F. Defense or Perfection of Title. Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property and must be capitalized. Treas. Reg. § 1.263(a)-2(d)(2)(i).

G. Selling Costs.

1. General Rules.

a) Capitalize commissions and other transaction costs paid to facilitate the sale of property. Treas. Reg. § 1.263(a)-1(c)(1).

b) Capitalized amounts are offset against amount realized or, if otherwise permitted, taken as a loss when the sale is abandoned. Treas. Reg. § 1.263(a)-1(c)(2).

2. Exceptions.

a) Amounts paid by dealers are ordinary and necessary business expenses. Treas. Reg. § 1.263(a)-1(c)(1).

b) Amounts paid to facilitate the disposition of a trade or business are governed by the intangibles regulations. *Id.*; see Treas. Reg. § 1.263(a)-5(g).

III. Improvements.

A. General Rules.

1. A taxpayer must capitalize amounts paid to improve a unit of property. Treas. Reg. § 1.263(a)-3(d)(1).

2. A unit of property is improved if amounts paid:

a) Materially increase the value of the unit of property; or

b) Restore the unit of property. *Id.*

B. Miscellaneous Rules.

1. A regulatory requirement is not relevant in determining whether an amount paid improves a unit of property. Treas. Reg. § 1.263(a)-3(d)(3).

2. If a taxpayer cannot practicably obtain the same type of part and therefore uses an improved replacement part, the use of the improved part

does not, by itself, result in an improvement. Treas. Reg. § 1.263(a)-3(d)(4).

3. Costs of repairs that do not directly benefit an improvement and costs of repairs that are not incurred by reason of an improvement are not required to be capitalized even if the repairs are performed at the same time as the improvement. However, an individual may capitalize amounts paid for repairs made at the same time as substantial capital improvements done as part of the remodeling or restoration of the taxpayer's residence if the residence is not used in the taxpayer's trade or business or for the production of income. Treas. Reg. § 1.263(a)-3(d)(5).

C. Unit of Property –

1. Step 1 – Is the property a network asset (i.e. railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines owned or leased by taxpayers in each of those industries)?

a) Yes – The unit of property (“UOP”) rules are not applicable. *See* Treas. Reg. § 1.263(a)-3(d)(2)(i).

b) No – Go to Step 2.

2. Step 2 – Is the property a building or structural component?

a) Yes – Combine the building and all structural components (as defined in § 1.48-1(e)(2)) and skip to Step 4. *See* Treas. Reg. § 1.263(a)-3(d)(2)(iv).

b) No – Go to Step 3.

3. Step 3 – Is the property a functionally interdependent component (i.e. placing one component in service is dependent on placing the other component in service)?

a) Yes – Combine all functionally interdependent components and go to Step 4, Question 1. *See* Treas. Reg. § 1.263(a)-3(d)(2)(ii).

b) No – Go to Step 4, Question 1.

4. Step 4

a) Step 4, Question 1 – Is the taxpayer engaged in a trade or business in an industry for which a Federal regulator has a uniform system of accounts (“USOA”) identifying a particular UOP?

(1) Yes – Identify the UOP in accordance with the USOA and skip to Step 5. *See* Treas. Reg. § 1.263(a)-3(d)(2)(iii).

(2) No –

(a) If the UOP is a building and structural components, skip to Step 5.

(b) Otherwise, go to Step 4, Question 2.

b) Step 4, Question 2 – Is the property tangible personal property as defined in § 1.48-1(c)?

(1) Yes – Make the UOP determination on the basis of the four exclusive factors (although no one factor is determinative or weighs more heavily than the others and the determination is not intended to be made on the basis of the number of factors indicating that a component is or is not a separate UOP) and then go to Step 5. *See* Treas. Reg. § 1.263(a)-3(d)(2)(v).

Factor 1 – Whether the component is:

- Marketed separately to the taxpayer by a party other than the seller/lessor of the property of which the component is a part at the time the property is initially acquired or leased;
- Acquired or leased separately by the taxpayer from a party other than the seller/lessor of the property of which the component is a part at the time the property is initially acquired or leased;
- Subject to a separate warranty contract (from a party other than the seller/lessor of the property of which the component is a part);
- Subject to a separate maintenance manual or written maintenance policy;
- Appraised separately; or
- Sold or leased separately by the taxpayer to another party.

Factor 2 – Whether the component is treated as a separate UOP in industry practice or by the taxpayer in its books and records.

Factor 3 – Whether the taxpayer treats the component as a rotatable part (a part that is removable from property, repaired or improved, and either immediately reinstalled on other property or stored for later installation).

Factor 4 – Whether the property of which the component is a part generally functions for its intended use without the component property.

(2) No – Go to Step 4, Question 3.

c) Step 4, Question 3 – Is the property real property other than a building and structural components? *See* Treas. Reg. § 1.263(a)-3(d)(2)(iv).

(1) Yes – Make the UOP determination on the basis of all the facts and circumstances and go to Step 5.

5. Step 5 – Does the taxpayer properly treat a component as a separate UOP for any Federal income tax purpose? *See* Treas. Reg. § 1.263(a)-3(d)(2)(vii).

a) Yes – Treat the component as a separate UOP.

b) No – Do not treat the component as a separate UOP.

The term “any Federal income tax purpose” includes:

- The use of different placed-in-service dates (other than for an improvement or a floor of a building);
- The use of different MACRS classes for the component and the property of which it is a part; and
- The proper recognition of a loss from the retirement, worthlessness, or abandonment of a component.

But claiming a tax credit does not constitute treatment as a separate UOP.

D. Material Increase in Value.

1. General Rule.

a) An amount paid materially increases the value of a UOP only if it:

(1) Ameliorates a condition or defect that either existed before the taxpayer acquired the UOP or arose during the production of the UOP, even if the taxpayer was not aware of the condition or defect at the time of acquisition or production;

(2) Is for work performed prior to the date the property is placed in service by the taxpayer;

(3) Adapts the UOP to a new or different use (including a permanent structural alteration to the UOP);

(4) Results in a betterment (including a material increase in quality or strength) or a material addition (including an enlargement, expansion, or extension) to the UOP; or

(5) Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, or quality of output of the UOP. Treas. Reg. § 1.263(a)-3(e)(1).

b) For purposes of determining whether there is a betterment or a material increase in capacity, etc., (under III.D.1.a)(4) or (5) above)

(1) If a particular event necessitates an expenditure, compare the condition of the property immediately after the expenditure with the condition immediately before the event (consistent with *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), *nonacq. on other grounds*, 1964-2 C.B. 8). Treas. Reg. § 1.263(a)-3(e)(3).

(2) If normal wear and tear necessitates the expenditure, compare the condition of the property immediately after the expenditure with the condition after the last time the taxpayer corrected the effects of normal wear and tear or, if the taxpayer has not corrected the effects of normal wear and tear, the condition when the property was placed in service by the taxpayer. *Id.*

2. Exception – An amount paid does not result in a material increase in value if the economic useful life of a UOP is less than 12 months and the taxpayer did not originally elect to capitalize the amount paid for the property. Treas. Reg. § 1.263(a)-3(e)(2).

IV. Restoration.

A. General Rule.

1. A taxpayer must capitalize amounts paid that restore a UOP. Treas. Reg. § 1.263(a)-3(f)(1).
2. Amounts paid restore a UOP if the amounts paid substantially prolong the economic useful life of the UOP. *Id.*

B. Economic Useful Life.

1. For a taxpayer with an applicable financial statement (“AFS”):
 - a) The economic useful life (“EUL”) is presumed to be the useful life used for purposes of determining depreciation in the AFS; and
 - b) The taxpayer may rebut the EUL presumption with clear and convincing evidence that the EUL for taxpayers without an AFS is significantly different. Treas. Reg. § 1.263(a)-3(f)(2)(i).
2. For a taxpayer without an AFS
 - a) The EUL is the period over which the property may reasonably be expected to be useful to the taxpayer determined by reference to the taxpayer’s experience with similar property, taking into account present conditions and probable future developments. Treas. Reg. § 1.263(a)-3(f)(2)(ii).
 - b) The factors considered in determining the EUL include:
 - (1) Wear and tear and decay or decline from natural causes;
 - (2) Normal progress of the art, economic changes, inventions, and current developments;
 - (3) Climatic and other local conditions peculiar to the taxpayer’s trade or business; and

(4) The taxpayer's policy as to repairs, renewals, and replacements. *Id.*

C. Substantially Prolonging EUL.

1. An amount paid substantially prolongs the EUL of the UOP if it extends the period over which the property may reasonably be expected to be useful to the taxpayer beyond the end of the taxable year immediately succeeding the taxable year in which the EUL of the UOP was previously expected to cease. Treas. Reg. § 1.263(a)-3(f)(3)(i).

2. Amounts paid will be deemed to substantially prolong the EUL of the UOP if:

a) Replacements – A major component or substantial structural part of the UOP is replaced with a new part or a part that has been restored to like-new condition, but replacement of a relatively minor portion of the physical structure of a UOP or a relatively minor portion of any of its major parts does not constitute the replacement of a major component or substantial structural part of the UOP;

b) Restoration to like-new condition – The expenditures result in the UOP or a major component or substantial structural part of the UOP being restored to like-new condition (including bringing the UOP or major component or substantial structural part to the status of new, rebuilt, remanufactured, or similar status under the terms of any Federal regulatory guideline or the manufacturer's original specifications); or

c) Restoration after a casualty loss – The taxpayer properly deducts a casualty loss under section 165 with respect to the UOP and the amounts paid restore the UOP to a condition that is the same or better than before the casualty. Treas. Reg. § 1.263(a)-3(f)(3)(ii)-(iv).

V. Repair Allowance Method.

A. General Rules.

1. The repair allowance method is optional and elective. Treas. Reg. § 1.263(a)-3(g)(1).

2. If elected, the repair allowance method applies to repair allowance property in all MACRS classes until taxpayer obtains permission to revoke the election. Treas. Reg. § 1.263(a)-3(g)(2).

3. The repair allowance method allows a taxpayer to “ignore” the previously discussed proposed regulations regarding improvements except for the UOP definition. Treas. Reg. § 1.263(a)-3(g)(1).
4. Section 263A still governs treatment of costs with respect to property produced by the taxpayer and property acquired for resale. *Id.*
5. Except for amounts paid for Excluded Additions, electing taxpayers deduct all amounts paid for materials and labor to repair, maintain, or improve all repair allowance property in a MACRS class up to the repair allowance amount for that MACRS class. Treas. Reg. § 1.263(a)-3(g)(3).
6. Amounts paid in excess of the repair allowance amount for a MACRS class are capitalized and indirect costs also are capitalized. Treas. Reg. § 1.263(a)-3(g)(3), (5).
7. Amounts paid for Excluded Additions (including indirect costs) are capitalized. Treas. Reg. § 1.263(a)-3(g)(3), (7).

B. Repair Allowance Amount.

1. Except in the case of buildings and structural components, the repair allowance amount is the average unadjusted basis of property in a MACRS class multiplied by the repair allowance percentage for that MACRS class. Treas. Reg. § 1.263(a)-3(g)(4)(i).
2. In the case of buildings and structural components, the repair allowance is applied separately to each UOP. Treas. Reg. § 1.263(a)-3(g)(4)(iv).

C. Treatment of Capitalized Amounts.

1. The taxpayer may treat the capitalized amounts as a single asset or allocate the capitalized amounts to specific repair allowance property in the MACRS class. Treas. Reg. § 1.263(a)-3(g)(5)(i).
2. The capitalized amount is treated as placed in service on the last day of the first half of the taxable year and is depreciated over the MACRS class life. *See* § 168(i)(6). Treas. Reg. § 1.263(a)-3(g)(5)(ii), (iii).
3. Special rules are provided for property depreciated under section 168(g) and public utility property. Treas. Reg. § 1.263(a)-3(g)(5)(iv)-(vi).

D. Excluded addition means any amount paid:

1. For the acquisition or production of a UOP;
2. To ameliorate a condition or defect that either existed before the taxpayer acquired the UOP or arose during the production of the UOP, even if the taxpayer was not aware of the condition or defect at the time of acquisition or production;
3. For work performed before the UOP is placed in service by the taxpayer;
4. That adapts the property to a new or different use; or
5. That increases the cubic or square space of a building. Treas. Reg. § 1.263(a)-3(g)(7).

E. Repair Allowance Percentages.

MACRS class	MACRS Recovery Period	Repair allowance percentage
3-year property.....	3	16.5
5-year property.....	5	10
7-year property.....	7	7.14
10-year property.....	10	5
15-year property.....	15	3.33
20-year property.....	20	2.5
Water utility property.....	25	2
Residential rental property.....	27.5	1.82
Nonresidential rental property.....	39	1.28
Railroad grading or tunnel bore.....	50	1.00

Treas. Reg. § 1.263(a)-3(g)(8).

VI. Effective Date and Method Changes.

A. Effective Date – Taxable years beginning after the publication of final regulations in the Federal Register. Treas. Reg. § 1.263(a)-3(j).

B. Method Changes – Guidance to be provided for automatic change to methods provided in the final regulations. 71 Fed. Reg. 48,590, 48,606 (2006); Treas. Reg. § 1.263(a)-3(k) (reserved).

