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The Long-Running Saga on Repairs v. Capitalization

-by Neil E. Harl*

In a filing with the Federal Register on September 13, 2013, the long-running saga on the line between repairs and capitalization for acquiring, maintaining, repairing and replacing tangible property added a new chapter. Only time will tell as to whether this will be followed by a more than temporary lull in the flow of new temporary, proposed and final regulations from the Department of the Treasury and notices and revenue procedures from the Internal Revenue Service on the subject. The five sets of regulations have generally traced a path toward greater simplification and less complexity since the first set of proposed regulations was issued in 2006.

History of the controversy

In 2004, the Internal Revenue Service indicated that regulations would be forthcoming that would clarify the handling of repairs as well as expenditures for improving and rehabilitating property. Proposed regulations were issued in 2006. Those regulations focused heavily on unit-of-property determinations and a proposed repair allowance method (RAM). Had those regulations been adopted it would have represented a significant shift in the rules governing whether those and similar types of expenditures could continue to be deducted or would have to be capitalized.

However, those regulations were withdrawn in a hail of controversy on March 10, 2008 and new regulations were proposed. Those regulations were, in turn, withdrawn and a new set of temporary regulations was issued on December 23, 2011. The temporary regulations were to become effective on or after January 1, 2012. IRS announced on November 20, 2012, that the temporary repair regulations had been amended to extend the effective date to tax years beginning on or after January 1, 2014, with final regulations expected in 2013. Ann. 2013-7 also stated that the effective date for T.D. 9564 was to be January 1, 2014.

With considerable fanfare, the Department of the Treasury on September 13, 2013, issued T.D. 9636 which contained final regulations that provide guidance on the application of I.R.C. §§ 162(a) and 263(a). Those final regulations undertook to clarify and expand the standards in the current regulations under I.R.C. §§ 162(a) and 263(a), replaced and removed temporary regulations under I.R.C. §§ 162(a) and 263(a) and withdrew proposed regulations that cross referenced the text of those temporary regulations. The final regulations do not finalize or remove the temporary regulations issued in 2011 under I.R.C. § 168 regarding

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general asset accounts and the disposition of property subject to I.R.C. § 168.18 Rather new proposed regulations were issued.19

The 2013 final regulations

The final regulations issued on September 13, 2013, are to be followed by all taxpayers commencing in tax years beginning on or after January 1, 2014.20

The stated objective of IRS in the final regulations is to reduce controversies with taxpayers which is to be accomplished by moving away from a “facts and circumstances” determination whenever possible as well as moving away from the subjective nature of the existing standards in general.

Five main areas. The final regulations make changes in each of five areas –

• Materials and supplies;21
• Repairs and maintenance;22
• Capital expenditures;23
• Amounts paid for the acquisition or production of tangible property;24 and
• Amounts paid for the improvement of tangible property.25

Reasons for changes mentioned in the Preamble to the regulations. As stated in the Preamble to the regulations, changes to the temporary regulations issued earlier were made principally to “clarify, simplify and refine” the regulations and to create a series of new “safe harbors.” IRS specifically noted the following –

• A revised and simplified de minimis safe harbor permitting a taxpayer to deduct certain amounts paid for tangible property if the taxpayer had an applicable financial statement, had written accounting procedures for expensing amounts paid for the property under specified dollar amounts and treated such amounts as expenses on its applicable financial statement.26
• The extension of the safe harbor for routine maintenance of buildings which involves “...the recurring activities that a taxpayer expects to perform as a result of the taxpayer’s use...to keep the building structure or each building system in its ordinarily efficient operating condition.”27
• An annual election for buildings that cost $1 million or less to deduct up to $10,000 of maintenance costs or, if less, two percent of the building’s adjusted income tax basis.28 The taxpayer must have average annual gross receipts of $10 million or less during the three preceding tax years. For a lease, the unadjusted basis of the building is equal to the total amount of rent, on an undiscounted basis, paid or expected to be paid over the entire lease term, including expected renewal periods.
• A new annual election to capitalize repair costs that are capitalized on a taxpayer’s books and records.29
• The clarification of the criteria for defining betterments and restorations to tangible property.30

Improving a unit of tangible property. The final regulations continue the requirement of capitalization of amounts to improve a unit of tangible property.31 A unit of property is considered to be improved if amounts are paid for activities performed by the taxpayer resulting in (1) a betterment to the particular unit of property; (2) a restoration of the property; or (3) adaptation of the property to a new (or different) use.

In conclusion

The tone and tenor of the new final regulations are significantly more friendly to taxpayers than their predecessors, dating back to 2006. That bodes well for those hoping that these regulations will mark the conclusion of the long saga on redrawing the line between repairs and expenses required to be capitalized.

ENDNOTES

4 See generally, Harl, “Temporary Regulations on Repairs, Depreciation and Capitalization,” 23 Agric. L. Dig. 41 (2012).
5 See Mackay, Department of the Treasury, Office of Tax Policy, speaking on September 25, 2013, to KPMG, LLC tax practitioners.
8 Id.
11 Id.
15 See, e.g., Temp Treas. Reg. § 1.162-4T(a) through (d) (repairs). Other sections had different effective dates).
18 Id.
19 NPRM REG 110732-13.
20 Treas. Reg. § 1.162-3(j). However, taxpayers are permitted to choose to apply the 2011 temporary regulations to taxable years beginning on or after January 1, 2012 and before the applicability date of the final regulations.
23 Treas. Reg. § 1.263(a)-(1).
24 Treas. Reg. § 1.263(a)-(2).
25 Treas. Reg. § 1.263(a)-(3).
26 Treas. Reg. §§ 1.263(a)-1(f), 1.162-3(f).
27 Treas. Reg. § 1.263(a)-3(i).
28 Treas. Reg. § 1.263(a)-3(h).
29 Treas. Reg. § 1.263(a)-3(n).
30 Treas. Reg. § 1.263(a)-3(j).
31 Treas. Reg. § 1.263(a)-(3).