## Final “Repair Regulations”: Improvements, Betterments, and Restorations

*In September 2013, the IRS released much-anticipated final “repair” regulations that explain when taxpayers must capitalize costs and when they can deduct expenses for acquiring, maintaining, repairing, and replacing tangible property. This article is part of a series discussing important features of the regulations; it focuses on the tax treatment of improvements, betterments, and restorations under the final regulations.*

## Improvements

The final regulations continue to require capitalization of amounts paid to improve a unit of tangible property. A unit of property is improved if amounts are paid for activities performed by the taxpayer resulting in:

* a betterment to the unit of property;
* a restoration of the unit of property; or
* adaptation of the unit of property to a new or different use.

Comment

A unit of property for this purpose consists of a group of functionally interdependent components, such as the parts of a machine, with the machine being treated as a unit of property. In the case of a building, the building (including its structural components) is a unit of property. However, certain major systems of the building—such as heating, air conditioning, and ventilation (HVAC); plumbing; and electrical—are treated as separate units of property for purposes of determining whether there has been a capitalizable betterment, restoration, or adaption to the system.

The final regulations retain the unit of property rules in the temporary regulations. For real property, the regulations continue to apply the rules to both the building structure and to specified building systems. They also keep certain simplifying conventions, including a routine maintenance safe harbor and the optional regulatory accounting method.

Comment

The IRS explained that application of the improvement rules to both the building structure and the defined building systems is necessary to help ensure that the improvement standards are applied equitably and consistently across building property.

## Removal Costs

The final regulations clarify that the cost of removing a depreciable asset or a component of a depreciable asset is not capitalized as an improvement if the taxpayer realizes gain or loss on the removed asset or component. If a taxpayer disposes of a component of a unit of property and the disposal is not a disposition on which gain or loss is realized, then the taxpayer deducts the costs of removing the component if the removal costs directly benefit or are incurred by reason of a repair to the unit of property. Otherwise, the removal costs are capitalized as part of the improvement costs to the unit of property.

Comment

Under proposed MACRS disposition regulations that were issued in conjunction with the final repair regulations, a taxpayer may recognize a loss on the retirement of a component of an asset, such as a structural component of a building, if the taxpayer makes an election to treat the retirement as a partial disposition of an asset and recognize the loss. This election should be exercised with caution because the final regulations retain the rule in the temporary regulations which requires the capitalization of any costs related to a repair as a restoration if a loss deduction is claimed. Under the temporary MACRS regulations, which are optionally effective for tax years beginning on or after January 1, 2012, and before January 1, 2014, loss recognition on the retirement of a structural component is mandatory, unless the taxpayer places the building in a general asset account.

## Safe Harbor for Small Taxpayers with Buildings

Small taxpayers complained that they could not afford to collect and maintain the documentation necessary to apply the improvement rules in the final regulations to their buildings. In response, the final regulations include an annual safe harbor election for buildings owned or leased by a taxpayer with an unadjusted basis (i.e., generally cost) no greater than $1 million.

The taxpayer must have average annual gross receipts of $10 million or less during the three preceding tax years. Gross receipts are specially defined and include income from sales (unreduced by cost of goods), services, and investments.

In the case of a lessee, the unadjusted basis of the building is equal to the total amount of (undiscounted) rent paid or expected to be paid over the entire lease term, including expected renewal periods.

Under the new exception, the small taxpayer is not required to capitalize improvements if the total amount paid for repairs, maintenance, improvements and similar activities during the year that are performed on the building does not exceed the lesser of $10,000 or two percent of the unadjusted basis of the building. Amounts deducted under the de minimis rule or the new safe harbor for routine maintenance are counted toward the $10,000 limit. No amount is deductible under the safe harbor for buildings if this limit (or the $1 million adjusted basis limit) is exceeded. The safe harbor is applied separately to each building owned or leased by the taxpayer.

Eligible property includes a building (including structural components and building systems) owned or leased by a qualifying taxpayer and, also, portions of buildings that are owned or leased and considered separate units of property under the regulations, such as an individual condominium or cooperative unit or office space. The safe harbor does not apply to costs paid with respect to exterior land improvements that are separate units of property.

Comment

Under the final regulations, small taxpayers do not have to analyze the building systems.

Comment

As with the $200 materials and supplies threshold, the IRS is given the authority to adjust the $10,000, 2-percent, and $1-million amounts in the future through published guidance.

The election is made annually on a timely filed (including extensions) original income tax return. In the case of a partnership or S corporation that owns or leases a building, the partnership or S corporation makes the election. The election may not be made by filing an application for a change in accounting method or on an amended return, unless permission to file a late election on an amended return is first obtained. The election is irrevocable.

Comment

A transitional rule allows taxpayers, by filing an amended federal tax return, to apply the safe harbor as contained in the final regulations to a tax year beginning in 2012 or 2013, even though a timely election was not initially made. This relief is also provided for certain other provisions that require an election.

## Betterments

In the final regulations, the IRS has clarified the betterment rules and revised two of the betterments tests. Under the temporary regulations, a betterment is defined as an expenditure that:

* ameliorates a material condition or defect that existed prior to the acquisition of the property or arose during the production of the property;
* results in a material addition to the unit of property (including a physical enlargement, expansion, or extension); or
* results in a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output.

Under the final regulations, no change is made to the first betterment test. However, the second and third tests are changed to eliminate the "results in" standard. Specifically, under the final regulations, a betterment under the two revised standards now includes an expenditure if it:

* is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property; or
* is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property.

The final regulations clarify that, if an addition or increase in a particular factor cannot be measured in the context of a specific type of property, then the factor is not relevant in determining whether there has been a betterment to the property. For example, the "productivity" or "output" standards, while relevant in analyzing a machine, would normally have no relevance to a building structure and, therefore, should be ignored when considering whether expenditures result in a betterment to a building structure.

The final regulations also clarify situations involving refreshing or remodeling retail stores in particular, by fine-tuning examples in which such actions move from being maintenance activities to betterments that must be capitalized.

Comment

Facts and circumstances taken into account in determining whether an expenditure results in a betterment include, but are not limited to, the purpose of the expenditure, the physical nature of the work performed, and the effect of the expenditure on the unit of property. The treatment of an expenditure on a taxpayer's applicable financial statement is removed by the final regulations as a factor in considering whether an expenditure results in a betterment since taxpayers apply standards that may differ significantly than the standards in the regulations in determining whether to capitalize a cost for financial accounting purposes.

## Restorations

The final regulations provide some relief from a rule in the temporary regulations which required a taxpayer to capitalize the entire cost of repairing property that was damaged in a casualty if the taxpayer adjusted the basis of the property as a result of claiming a casualty loss. Capitalization was required even if the adjusted basis of the building (generally, the amount to which the casualty loss is limited) was less than the amounts that could otherwise be deducted as a repair expense. Even if a taxpayer chooses not to claim a casualty loss, the basis adjustment for the loss that could be claimed is required, and the deduction of related repair expenses is prohibited under the temporary regulations.

The final regulations revise the casualty loss rule to permit a deduction for amounts spent in excess of the adjusted basis of the property damaged in a casualty event, provided they would otherwise be considered deductible repair expenses. A taxpayer is still required to capitalize amounts paid to restore damage to property that would be capitalized without regard to the casualty loss rule, but the costs required to be capitalized under the casualty loss rule are limited to the excess of (1) the taxpayer's basis adjustments resulting from the casualty event, over (2) the amount paid for restoration of damage to the unit of property that are otherwise considered capitalizable restorations. Casualty-related expenditures in excess of this limitation may be deducted as repair expenses if they so qualify.

Example

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

## Rebuilt Like New

The final regulations retain the rule that a capitalizable restoration includes rebuilding a unit of property to a like-new condition after the end of its class life. A property is rebuilt to a 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. The final regulations clarify that generally a comprehensive maintenance program, conducted according to the manufacturer's original specifications, even though substantial, does not return a unit of property to like-new condition.