

TIMPE

Timpe CPAs, LLC
4212 W. 71st Street, Suite C
Indianapolis, IN 46268

February 7, 2015

RE: New Repair Regulations

In September 2013, the IRS issued final regulations to clarify the difference between capital improvements and repairs. These regulations apply to taxable years beginning January 1, 2014. The IRS further clarified these regulations in the release of transitional guidance for materials and supplies, and costs to acquire, maintain and improve tangible property (Rev. Proc. 2014-16) and disposition and general asset account treatment (Rev. Proc. 2014-17).

As capital assets are depreciated over the life of the asset, their impact is not just in the year in which the expenditure was made / placed in service. *As a result, these regulations are not just prospective.* Rather prior year expenditures need to be reviewed in light of these regulations as well. Furthermore, each taxpayer must review their current treatment of materials & supplies, repairs & costs to improve property, costs of acquiring / producing property, costs of improving property, and treatment of dispositions.

Taxpayers should start by reviewing their capitalization policies in light of these regulations. The taxpayer should subsequently review their general ledger expense accounts used to track tangible property expenditures, repairs, and materials and supplies.

Due to these regulations, generally any tax payer with tangible property will have a change of accounting method resulting in the filing of a Form 3115 Application for Change in Accounting Method. This form should generally be filed to illustrate overall compliance with the new regulations. As a result, there may be a Section 481 adjustment to capture this change. In addition, the regulations provide a few annual Safe Harbor elections that the taxpayer can make .

Major Changes

These regulations provide a general framework for distinguishing capital expenditures from supplies, repairs, maintenance, and other deductible expenses. Five main categories of expenditures were addressed:

- Reg 1.162-3 Materials & Supplies
- Reg 1.162-4 Repairs
- Reg 1.263(a)-1(f) and 1.162-3(f) De minimis safe harbor rules
- Reg 1.263(a)-2 Acquisition or production of tangible property
- Reg 1.263(a)-3 Improvement to tangible property

The attached document from TheTaxBook - 2014 Tax Year summarizes these regulations. The following provides additional highlights / clarifications:

Unit of Property: Included in these regulations is a change in the definition of Unit of Property. Under prior regulations, the Unit of Property for a building consisted of the building & all its structural components as one asset. These new regulations consider *the building structure separate from 8 of its components*: HVAC, Electrical Systems, Elevators, Escalators, Fire Protection Systems, Gas Distribution System, Plumbing, and Security Systems. Taxpayers must apply the improvement / repair standards separately to the building structure and to each specifically defined building system. In addition, under the new regulations related to dispositions, the treatment of improvements to these separately stated components will be treated differently as well. (See below for Disposition Rules for these changes.)

A Unit of Property for real and personal property other than buildings is defined as a unit consisting of all components that are functionally interdependent. Components are functionally interdependent if the placing in service of one component is dependent on the placing in service of another component.

Dispositions: Under Section 1.168(i)-8 the disposition rules apply to a partial disposition of an asset; for example, the disposition of a roof or portion of a roof. The partial disposition rule minimizes circumstances in which an original part and its replacement were both required to be capitalized and depreciated simultaneously. Previously, the original cost of the roof was included as part of the building and continued to depreciate even though it no longer existed and was replaced. The new expenditures were also capitalized & depreciated.

As this is a significant change from prior regulations, you may have costs *currently capitalized* that under the new regulations can be considered a partial disposition. To take advantage of this disposition, for 2014 the taxpayer would file a Form 3115 (a 196 or 205 Election). Note that after 2014 only items disposed of in the current year could be considered for a disposition (whole or partial). For example, if the roof is replaced in 2016, the taxpayer would write off existing roof costs in 2016. However, if in 2016, the taxpayer wants to write-off old roof costs and the roof was replaced in 2012, the partial disposition would not be allowed.

The regulations provide examples for determining the unadjusted depreciable basis of the disposed asset if it is impracticable to determine this basis from current records. Methods include 1) discounting the cost of the replacement asset to its placed in service year cost; 2) a pro rata allocation of the unadjusted depreciable basis in the multiple asset account; 3) a cost allocation study; 4) Any other reasonable method if it is impracticable to determine the unadjusted basis from current records.

Safe Harbor Rules & Other Elections:

Materials & Supplies: Items that are \$200 or less can be expensed as de minimus. A Form 3115 change of accounting method should be filed (DCN 186 / 187) in 2014. This accounting policy would remain in effect for future years;

Capital Expenditure De Minimus: Under 1.263(a)-1(f) a taxpayer may expense items under \$500. Note that this is a per item expense. For example, the taxpayer purchases 4 chairs at \$400 each. Even though the total cost is \$1,600, these items can be expensed as each item is less than the \$500 limit. This is an annual election to be made with a

statement on the taxpayer's return. This does not require a Form 3115. (Note the safe harbor limit increases to \$5,000 per item if the taxpayer has audited financial statements and a written capitalization policy in effect at the beginning of the tax year.)

Qualifying Small Taxpayer - Eligible Building: A qualified small taxpayer may elect to not apply the improvement rules to an eligible building property if the total amount paid during the taxable year for repairs, maintenance, improvements and similar activities does not exceed the lesser of \$10,000 or 2% of the unadjusted basis of the building. A qualified small taxpayer has gross receipts of \$10 million or less, and an eligible building has unadjusted basis of \$1 million or less. This is an annual election made through a statement on the return (not a Form 3115).

Election to Capitalize Repairs & Maintenance: The regulations allow a tax payer to capitalize R&M expenditures as an asset and depreciate if incurred as part of the trade or business and the taxpayer treats these costs as such in their books & records. If elected, all amounts paid for R&M must be treated as capital expenditures in the year the election is made. This is an annual election that cannot be revoked.

In General:

The de minimis safe harbor rules reduce the administrative burdens of evaluating every cost incurred by a taxpayer with respect to tangible property by allowing many taxpayers to treat costs below the applicable threshold as deductible. If costs are incurred above the threshold, the taxpayer then determines whether the amounts are properly deductible or capitalizable under the provisions of the regulations.

Overall, an improvement to a unit of property must be capitalized if it results in 1) Betterment or permanent improvement; 2) Restores the unit of property to its original value or use; or 3) adapts the unit of property to a new or different use. Routine maintenance continues to be expensed if it does not materially increase capacity, productivity, efficiency, strength, quality or output of the unit of property. Expense would be considered routine if expected to perform more than once in the assets' life or at least every ten years if a building or component.

Commuting. IRS regulations for investment expenses specifically mention commuter's expenses as being nondeductible, making the same commuting rules that apply to business expenses also apply to passive rental activities. [Reg. §1.212-1(f)]

Travel expenses. Expenses for traveling away from home, such as transportation and lodging, are deductible if the primary purpose of the trip is to manage, collect rental income, conserve, or maintain the rental property. See Tab 8 for more information about travel expenses.

Interest. Do not deduct prepaid interest when paid. Instead, deduct prepaid interest in the period to which it applies. Points or loan origination fees paid for rental property are deducted over the life of the loan.

Limits on Rental Losses

Two sets of rules may limit the amount of loss deductible by a taxpayer. They must be considered in the following order.

- At-risk rules. See page 7-14.
- Passive activity loss limits. See page 7-10.

Repairs and Improvements

Cross References

- IRC §263, *Capital expenditures*
- Reg. §1.162-3 through -4
- Reg. §1.263(a)-1 through -3

Related Topics

- Depreciation, Tab 9
- Sale of Business Property, Tab 6
- Depreciation Recapture, Tab 6



If a taxpayer improves depreciable property, he or she must treat the improvement as separate depreciable property. Improvement means an addition to or partial replacement of property that results in a betterment of the unit of property, restores the unit of property, or adapts the unit of property to a new use.

Incidental repairs and maintenance of property are not capital expenditures. A taxpayer can generally deduct the cost of repairing business property in the same way as any other business expense.

Some common examples of what constitutes repairs and improvements are listed in the chart below.

Repairs vs. Improvements

Repairs	Improvements
<p>Costs that:</p> <ul style="list-style-type: none"> • Keep the property in good operating condition. • Do not materially add value to the property. • Do not substantially prolong the property's life. 	<p>Costs that:</p> <ul style="list-style-type: none"> • Improve or better the property. • Restore the property. • Adapt the property to new or different uses.
Deductible as a current expense.	Must be capitalized and depreciated.*
<p>Examples:</p> <ul style="list-style-type: none"> • Repainting inside or out. • Fixing gutters. • Fixing damaged carpet. • Fixing leaks. • Plastering. • Replacing broken windows. 	<p>Examples:</p> <ul style="list-style-type: none"> • Room additions. • Remodeling. • Landscaping. • New roof. • Security system. • Replacing gravel driveway with concrete.

* The cost of an improvement is depreciated according to the MACRS class and recovery period of the underlying property. See Tab 9 for more information on MACRS classes and recovery periods.

Example: Gina repairs a small section on one corner of the roof of a rental house. She deducts the costs as a rental expense. However, if she completely replaces the roof, the new roof is an improvement because it increases the value and lengthens the life of the roof. Gina would depreciate the cost of a new roof.

New Repair Regulations

In September 2013, the IRS issued final regulations to clarify the difference between capital improvements and repairs. The final regulations apply to taxable years beginning January 1, 2014.

Transition rules. Taxpayers were allowed to elect certain rules for tax years beginning January 1, 2012, and ending on or before September 19, 2013, by filing an amended return on or before 180 days from the return due date including extensions.



Unit of property. Under prior regulations, the unit of property for a building consisted of the building and its structural components as one whole property. Current treasury regulations separate buildings into eight components. [Reg. §1.263(a)-3(e)(2)(ii)(B)]

- Heating and air conditioning.
- Electrical system.
- Escalators.
- Fire protection system.
- Gas distribution system.
- Plumbing.
- Security system.

Materials and Supplies

Materials and supplies are deductible in the year first used in the taxpayer's trade or business. Materials and supplies are non-inventory items purchased to repair, maintain, or improve a unit of property and include the following items. [Reg. §1.162-3(c)(1)]

- Components acquired to maintain, repair, or improve a unit of tangible property that are not acquired as part of a unit of property.
- A unit of property with a useful life of 12 months or less.
- A unit of property with an acquisition cost of \$200 or less.
- Rotable spare parts acquired for use in a unit of property and that can be removed, repaired, and reinstalled in the same or other property.
- Standby emergency spare parts acquired when machinery or equipment is acquired and set aside for use as replacements

Note: If the taxpayer elects to use the de minimis safe harbor method to expense and not capitalize certain expenses, the safe harbor method must also be used for all materials and supplies [Reg. §1.162-3(f)]. See *De minimis safe harbor election*, page 7-7.

Example #1: George provides billing services to his customers. In 2014, George pays amounts to purchase 50 scanners for use by his employees. Each scanner costs \$150. In 2015, George's employees begin using 35 of the scanners, and George stores the remaining 15 scanners for use in a later taxable year. The scanners are materials and supplies, and the amounts George paid for 35 of the scanners are deductible in 2015, the taxable year in which each machine is first used in business.

Example #2: Assume the same facts as Example #1, except that George's scanners qualify for the de minimis safe harbor and George makes the election to apply the safe harbor to amounts paid for the scanners rather than treat these amounts as costs of materials and supplies. George may deduct the amounts paid for all 50 scanners in 2014, the taxable year the amounts are paid.

Election to capitalize certain materials and supplies. Taxpayers may elect to capitalize and depreciate amounts paid for rotatable, temporary or standby emergency spare parts. The election can be revoked by filing a request for obtaining a letter ruling and consent of the IRS.

Improvements

The regulations require capitalization of permanent improvements, betterments, restorations, and adaptations as they relate to certain units of property. The expenses capitalized for improving property can be depreciated as if the improvement were separate property. [Reg. §1.263(a)-3]

De minimis safe harbor election. A taxpayer can expense amounts paid for property that do not exceed \$5,000 per invoice if the taxpayer has an applicable financial statement. If the taxpayer does not have an applicable financial statement, then the amount is limited to \$500 per invoice. An applicable financial statement is one required for SEC reporting, an audited financial statement by a CPA, or a financial statement required by certain government agencies. [Reg. §1.162-3(c)(3)(iii)]

Small taxpayer safe harbor election. A new election is available for qualifying small taxpayers who may elect to not apply the improvement rules to an eligible building property if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of:

- \$10,000, or
- 2% of the unadjusted basis of the building. [Reg. §1.263(a)-3(h)]

Qualifying small taxpayer. A qualifying small taxpayer is a taxpayer with gross receipts of \$10 million or less.

Eligible building. An eligible building is a building unit of property that is owned or leased by the qualifying taxpayer with an unadjusted basis of \$1 million or less.

Making the small taxpayer election. Under this election, a taxpayer includes amounts not capitalized under the de minimis safe harbor election and under the routine maintenance safe harbor to determine the annual amount paid for repairs, maintenance, improvements, and similar activities performed on the building. The election may be made annually on a building-to-building basis by including a statement on the taxpayer's timely filed (including extensions) tax return for the year the costs are incurred for the building. A taxpayer may not revoke this election.

Routine maintenance safe harbor. A taxpayer can expense amounts paid for routine maintenance if it is deemed not to improve the property. For a building, the safe harbor applies if the taxpayer expects to perform the maintenance more than once within a 10-year period.

Election to capitalize repair and maintenance costs. The regulations permit a taxpayer to elect to treat amounts paid during the taxable year for repair and maintenance as amounts paid to improve property and as an asset subject to the allowance for depreciation, as long as the taxpayer incurs the amounts in carrying on a trade or business and the taxpayer treats the amounts as capital expenditures on his or her books or records. A taxpayer who elects this treatment must apply the election to all amounts paid for repair and maintenance treated as capital expenditures on his or her books or records for the taxable year.

Making the election. The election is made by attaching a statement to the taxpayer's timely filed tax return (including extensions) for the taxable year in which the improvement is placed in service. The election cannot be revoked. [Reg. §1.263(a)-6]

Personal Use of Rental Property—Roommates and Boarders

Renting part of property. If a portion of property is rented out, and a portion is used for personal purposes, any reasonable method of allocating expenses between personal and rental use is allowed. For example, dividing the cost of utilities by the number of people living in the home, or dividing expenses based on square footage of use, are reasonable methods.

Example: Phil owns and lives in a personal residence that has 1,800 square feet of floor space. Phil takes in a boarder and rents out a room that is 12 × 15 feet, or 180 square feet. Phil can allocate 10% of the home's expenses to the rental. The total utility bills for the year are \$2,700. Phil can deduct \$270 ($\$2,700 \times 10\%$) from rental income on Schedule E.



Phone expense. The cost of the first phone line into a home that is used for both personal and rental purposes is not deductible.

Direct rental expenses. A full deduction is allowed for expenses that belong only to the rental part of the property. Examples of fully-deductible rental expenses include painting a room that is rented out, additional liability insurance attributable to the rental, and the cost of a second phone line that is strictly for the tenant.

Mixed-Use Property— Vacation Homes (IRC §280A)

Cross References

- Schedule E (Form 1040), *Supplemental Income and Loss*
- IRS Pub. 527, *Residential Rental Property*
- IRC §280A, *Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.*

Related Topics

- Business Use of Home, Tab 5
- Business Deductions, Tab 8
- Depreciation, Tab 9

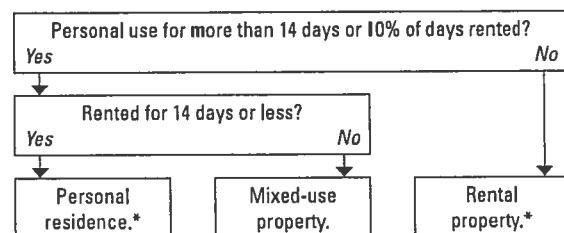


Allocating Expenses: Personal vs. Rental

When a dwelling unit is used for both personal purposes and rented out during the year, treatment of income and expenses depends on the amount of personal use.

Dwelling unit defined. A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property if the property contains basic living accommodations, such as sleeping space, toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

How to Classify Rental Property for Tax Treatment



* Rental income not reported, expenses not allowed, report real estate taxes and qualified mortgage interest on Schedule A.

** Any rental income must be reported even for periods of 14 days or less.