

# New Capitalization Rules: Applying to Repairs to Personal Property



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## Article 3 of our 4 part series

In late 2011, the Treasury Department and the IRS issued a new set of temporary and proposed regulations that define when an expenditure is deductible as a repair expense or is classified as a capital expenditure. In Article 2 (Capitalization Rules: Acquisition of Real Property), we discussed the regulations as they relate to real property. In this article, we focus on the new capitalization regulations under Section 263 (a) and how they relate to personal property.

Historically, costs have been held to be deductible repair expenses if they are incidental in nature and neither add to the value of a unit of property nor prolong its useful life. Costs have had to be capitalized if they are permanent improvements or betterments that increase the value of the property, restore its value or use, prolong its useful life or adapt it to a new or different use.

### Unit of Property (UOP)

The starting point for determining whether a particular expenditure made to personal property is a deductible repair expense is to identify the unit of property (UOP). For property other than buildings, the new regulations adopt a functional interdependence test. Under this test, two components comprise a single unit of property if placing one component in service is dependent on placing the other components in service as well. For example, an airplane has several components such as landing gear, airframe and engines that must be placed in service at the same time. As a result, the airplane is the unit of property not the engines or other components.

This concept of unit of property is very important. In the example of the airplane, costs incurred to repair or rebuild one of the component parts of the airplane would generally be deductible as repair expenses.

Similar examples are contained in the regulations for trucks and railroad locomotives. In another example, a law firm providing legal services acquires a laptop computer and printer for use by its employees in providing legal services. The placing in service of the laptop is not dependent on the placing in service of the printer. As a result, under the regulations, each of the laptop and printer is a separate UOP.

However, if for federal depreciation purposes, a taxpayer decides to treat components of a unit of property as being in separate classes for depreciation, then each component depreciated in this manner becomes a separate UOP. For example if a taxpayer in the freight business uses a different depreciation life to depreciate truck tractors and tires, then the taxpayer must treat the tractor and tires as different UOPs.

The regulations contain special UOP rules for “plant property” and “network assets”. We will cover these special rules in future articles.

### General Rule for Capitalization

Under the new regulations, costs must be capitalized if they are paid to improve a unit of property. A unit of property is improved if the costs result in a betterment of the property, a restoration of the property, or adapts the unit of property to a new and different use.

### Betterments

The regulations state that an expenditure results in a betterment if it:

- › It improves a material condition or defect that existed prior to the taxpayer's acquiring the UOP
- › It results in a material addition (enlargement, expansion, or extension) to the UOP, or
- › It results in a material increase in capacity, productivity, efficiency, strength, or quality of the UOP

To determine as to whether one or more of these tests is met is based on the facts and circumstances of the expenditure. The regulations provide many examples that taxpayers' will have to refer to in order to properly classify the expenditures, and these rules may be difficult to apply to everyday situations.

In one example contained in the regulations, a retailer installed cash registers in one of its locations. The initial acquisition costs for the cash registers were capitalized. The retailer loses its lease and moves the cash registers to a new location. The cost to move and reinstall the cash registers does not result in a betterment and as a result, the cost to move and reinstall the registers do not have to be capitalized.

In another example, the costs to move and reinstall a machine used in a manufacturing process with a new component that increases the manufacturing capacity of the machine must be capitalized as a betterment.

All three of the tests under the betterment rule state that the costs must be “material”, again using a facts and circumstances test. The regulations provide several examples of the application of this “material” standard. In one example, a taxpayer acquires a machine just prior to the performance of its three-year scheduled maintenance program. In the example, the cost to perform the maintenance program is not considered material even though it fixes a pre-existing condition.

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## Restorations

Costs incurred to restore a UOP must be capitalized. An amount is treated as a restoration only if it:

- › Replaces a component of a UOP where the taxpayer has deducted a loss for that component
- › Repairs damage to a UOP for which taxpayers have claimed a casualty loss deduction
- › Returns the UOP to its ordinarily efficient operating condition if the UOP has deteriorated to a state of disrepair and is no longer functional
- › Results in the rebuilding of the UOP to a like new condition after the end of its class life (not depreciable life) or
- › Replaces a part or component that comprises a major component of a UOP

Again the regulations require taxpayers to examine the facts and circumstances related to a particular expenditure, and again taxpayers must look to the examples in the regulations to see how to interpret the regulations.

An example in the regulations covers a taxpayer in the railroad business that operates a fleet of railroad cars. The cars are depreciated over 7 years, but the class life of the railroad cars under IRC Section 168 is 14 years. Every 8 to 10 years, the railroad completely rebuilds the railroad cars. Even though the cars are restored to a "like-new" condition, the railroad does not have to be capitalized the rebuild costs, because, under the regulations, the costs are incurred prior to the end of the class life of the railroad cars.

In another example, a taxpayer that operates a common carrier fleet of petroleum hauling trucks and tank trailers. The trucks and trailers are separate UOPs. Costs incurred to replace the tanks on the trailers must be capitalized because the tank is a major component of the UOP, under the regulations in this example.

## New or Different Use

Finally, under the regulations, the cost of adapting a unit of property to a new or different use must be capitalized. For example, the costs of converting a taxpayer's manufacturing facility to a showroom facility must be capitalized. Most of the examples under this section of the regulations concern buildings and are not much help in applying these rules to personal property UOPs.

## Routine Maintenance Safe Harbor

This safe harbor under the regulations applies only to UOPs that are not buildings or structural components of buildings. Routine maintenance refers to recurring activities that the taxpayer expects to perform as a result of its use of the UOP in order to keep the UOP in its ordinarily efficient operating condition. These activities include inspections, cleaning and testing, and the replacement of parts with comparable parts that are not considered upgrades.

This safe harbor applies only if, at the time the UOP is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the UOPs class life under Section 168 (not depreciable life).

Costs incurred under this safe harbor do not have to be capitalized. There are several examples in the regulations that interpret this safe harbor including scheduled maintenance on tug boat engines and periodic inspections of aircraft engines that stand for the proposition that these costs are expensed and repairs and not capitalized.

## Conclusion

As you can tell from this article, the rules contained in these regulations are somewhat complex, and will be very difficult to apply to everyday situations. Taxpayers will have to scrutinize their repair expenditures closely to comply with these new rules and may have to change their tax accounting methods to properly apply these rules.

The Keiter Tax team is well versed in the many facets of the capitalization regulations. Should you have any questions related to this article, please feel free to contact Mike Gracik ([mgracik@keitercpa.com](mailto:mgracik@keitercpa.com)) or your Keiter Tax professional for further clarification.

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