

Chapter 2: Capitalization or Repair

Scope of the New Regulations.....	A44	Change of Accounting Method	A73
Materials and Supplies.....	A44	Applicability Dates	A75
Units of Property	A52	Transitional Provisions	A76
Repairs and Improvements	A58	Appendix A — IRS Cost Segregation ATG	A78
Applicable Financial Statement	A65	Appendix B — Automatic Changes of Accounting Method (Form 3115 must be filed)	A90
New Safe Harbors.....	A65		

Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

IRC §162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business, including amounts paid for incidental repairs. IRC §263(a) denies a deduction for any amount paid for new property or for permanent improvements or betterments that increase the value of any property, or amounts spent to restore property. The regulations are designed to assist in distinguishing between amounts paid to acquire or produce tangible property and amounts paid to improve existing property.

In general, taxpayers should always capitalize amounts paid to acquire or produce tangible property, unless the expenditure qualifies as materials and supplies, or it qualifies under the de minimis safe harbor.

TD 9636, issued in September 2013, contains final regulations that provide guidance on the treatment for amounts paid to acquire, produce, or improve tangible property. Although still allowing for some latitude about what is a repair and what is an improvement, TD 9636 provides several more objective standards. TD 9636 also establishes safe harbors and provides a criterion: whether the action (e.g., the repair) would normally be expected to be performed more than once during a relevant period.

The taxpayer's accounting method must be in compliance with the new regulations. This extends to all tangible property subject to depreciation now on the taxpayer's books. It also extends to items that may have been erroneously expensed or depreciated in previous years and are within their recovery periods.

It is estimated that these new regulations will affect about four million taxpayers. They will affect all taxpayers that acquire, produce, or improve tangible property, including small businesses and other for-profit institutions.

Note. Under the due diligence requirement of Circular 230, tax practitioners must conform with TD 9636.

SCOPE OF THE NEW REGULATIONS

The 13 separate regulations contained in TD 9636 replace the temporary regulations of TD 9564,¹ which were issued in 2011. The new regulations encompass the following subjects.

- Materials and supplies (Treas. Reg. §1.162-3)
- Repairs (Treas. Reg. §1.162-4)
- Rentals (Treas. Reg. §1.162-11)
- Obsolescence of nondepreciable property (Treas. Reg. §1.165-2)
- Leased property (Treas. Reg. §1.167(a)-4)
- Accounting for depreciable property (applicability note modifying Treas. Reg. §1.167(a)-7)
- Retirements (applicability note modifying Treas. Reg. §1.167(a)-8)
- Accounting for MACRS property (Treas. Reg. §1.168(i)-7)
- Capital expenditures, in general (Treas. Reg. §1.263(a)-1)
- Amounts paid to acquire or produce tangible property (Treas. Reg. §1.263(a)-2)
- Amounts paid to improve tangible property (Treas. Reg. §1.263(a)-3)
- Election to deduct or capitalize certain expenses (Treas. Reg. §1.263(a)-6)

MATERIALS AND SUPPLIES

Treas. Reg. §1.162-3, as amended by TD 9636, clarifies what are considered materials and supplies that may be expensed.

GENERAL RULES

Under Treas. Reg. §1.162-3, materials and supplies are divided into two classes that affect the timing of the deduction.

1. **Incidental materials and supplies** are those carried on hand and are not usually accounted for by inventory, record of consumption, and so on. **The cost of incidental materials and supplies is generally deductible in the year these amounts are paid** (or incurred, if the taxpayer uses the accrual method), provided that this clearly reflects taxable income.
2. **Nonincidental materials and supplies** are those that the taxpayer accounts for by taking a physical inventory or for which a record of consumption is otherwise kept. **Nonincidental materials and supplies are generally deductible in the tax year in which they are first used or consumed** in the taxpayer's operations.

Note. The treatment of materials and supplies for farmers is governed by Treas. Reg. §1.162-12(a). This regulation allows a farmer to fully deduct amounts expended in conducting the farming business. For farmers, the deduction for nonincidental materials and supplies is limited to such items actually used or consumed during the tax year. Thus, the distinction in the new regulations between incidental and nonincidental materials and supplies is not applicable to farmers.

¹. TD 9564, 2012-14 IRB 614.

DEFINITION OF MATERIALS AND SUPPLIES

According to Treas. Reg. §1.162-3, materials and supplies are any tangible property used or consumed in the taxpayer's operations, is not inventory, and **meets at least one of the following criteria.**²

1. Is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and **that is not acquired as part of any single unit of tangible property** (due to the complexity of the definition, "unit of property" is defined in detail later.)
2. Consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations
3. Is a unit of property that has an **economic useful life** of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations

Note. Unlike previous asset classifications, the economic useful life for these purposes is not inherent in the property. Instead, it depends on the use of the property and the expectations of its longevity for the business or the production of income **in the hands of and as used by the taxpayer.** This period is determined by considering the taxpayer's experience with similar property, taking into account present conditions and probable future developments. For further details, see Treas. Reg. §1.167(a)-1(b).³ Additionally, if a taxpayer has an applicable financial statement (AFS) and has depreciated the property for financial accounting purposes, the economic useful life is the same as that first used for depreciation on the AFS.⁴ (Applicable financial statements are discussed later.)

4. Is a unit of property that has an acquisition cost or production cost (determined under IRC §263A) of \$200 or less or an amount provided in further guidance in the Federal Register or the Internal Revenue Bulletin

Note. For taxpayers eligible for the de minimis safe harbor, the safe harbor (defined later) may be used instead of criteria 3 or 4 to allow expensing. If using the safe harbor instead of criterion 4, the critical threshold per item is either \$500 or \$5,000, depending on whether the taxpayer has an AFS. **In this case, however, all items — materials, supplies, and other assets — qualifying for the safe harbor in the elected taxable year must be expensed under the safe harbor.** When either method of expensing could be used, the choice of which to use affects the timing of the deduction. The de minimis safe harbor results in a deduction in the taxable year the cost is paid or incurred, whereas nonincidental materials and supplies treatment are deductible only in the taxable year that the property is first used or consumed.⁵

Amounts expensed under the safe harbor do not count against the IRC §179 limit.

5. Is otherwise identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as materials and supplies for purposes of this regulation

² Treas. Reg. §1.162-3(c)(1).

³ Treas. Reg. §§1.162-3(c)(4)(i) and 1.167(a)-1(b).

⁴ Treas. Reg. §1.162-3(c)(4).

⁵ Treas. Reg. §1.162-3(a)(1).

Example 1. Norton Industries provides consulting services to its customers. In 2014, Norton purchases 50 laptop computers. Each laptop computer is a separate unit of property, costs \$400, and has an economic useful life of more than 12 months. Also in 2014, Norton purchases 50 office chairs to be used by its employees. Each office chair is a unit of property that costs \$100.

Norton has an AFS and a written accounting policy at the beginning of 2014 to expense amounts paid for units of property costing \$500 or less. Norton treats amounts paid for property costing \$500 or less as an expense on its AFS in 2014.

The laptop computers are **not** materials or supplies: they cost more than \$200, last more than 12 months, and do not meet any of the other five criteria in the preceding list. Therefore, the amounts Norton pays for the computers must generally be capitalized.

The office chairs are materials and supplies because they cost less than \$200 each. Thus, the amounts paid for the office chairs are deductible in the taxable year in which they are first used in Norton's business.

However, if Norton properly elects to apply the de minimis safe harbor to amounts paid in 2014, then, as an all-or-nothing election, the safe harbor applies to **all eligible acquisitions**. Norton **must** apply the de minimis safe harbor to amounts paid for the computers **and** the office chairs. Under the de minimis safe harbor, Norton may not capitalize the amounts paid for the computers nor treat the office chairs as materials and supplies. Instead, **Norton must deduct the amounts paid for the computers and the office chairs in 2014 as operating expenses.**⁶

ROTABLE, TEMPORARY, AND STANDBY EMERGENCY SPARE PARTS

Rotable, temporary, and standby emergency spare parts meet the first criteria of materials and supplies. To summarize, these spare parts are items of tangible property, other than inventory, that are used or consumed in the taxpayer's operations and that are components acquired to maintain, improve, or repair a unit of tangible property owned, leased, or serviced by the taxpayer. An item treated as a spare part may not be one that was acquired as part of any single unit of property.⁷

- **Rotable spare parts** are materials and supplies that are acquired for installation on a unit of property but which may be later removed, repaired, or improved, and then either reinstalled on the same or a different unit of property or stored for later installation and use.⁸
- **Temporary spare parts** are materials and supplies that are used temporarily until a new or repaired part can be installed, and then are removed and stored for later use with the same or another unit of property.⁹
- **Standby emergency spare parts** are materials and supplies that meet all of the following criteria.¹⁰
 - ♦ Acquired when particular machinery or equipment is acquired (or later acquired and set aside for use in particular machinery or equipment)
 - ♦ Set aside for use as replacements to avoid substantial operational time loss caused by emergencies due to particular machinery or equipment failure
 - ♦ Located at or near the site of the installed related machinery or equipment in order to be readily available when needed
 - ♦ Directly related to the particular machinery or piece of equipment it serves

⁶ Adapted from Treas. Reg. §1.162-3(h), Example 14.

⁷ Treas. Reg. §§1.162-3(c)(2), 1.162-3(c)(3), and 1.162-3(c)(1)(i).

⁸ Treas. Reg. §1.162-3(c)(2).

⁹ Ibid.

¹⁰ Treas. Reg. §1.162-3(c)(3).

- ♦ Normally expensive
- ♦ Only available on special order and not readily available from a vendor or manufacturer
- ♦ Not subject to normal periodic replacement
- ♦ Not interchangeable in other machines or equipment
- ♦ Not acquired in quantity (generally, only one is on hand for each piece of machinery or equipment.)
- ♦ Not repaired and reused

Example 2. Mario owns several high-performance custom race cars that he races at the Daytona 500 and other races on the NASCAR circuit. They all use the same type of high-performance engine, of which Mario maintains a standing stock. All engines in Mario's stock were acquired separately — not with any car. To ensure that his engines are at their best for the next race, Mario has the engine removed from the car after each race, torn down, and rebuilt. When the engine is removed, it is replaced with another interchangeable engine from Mario's stock of top-notch rebuilt engines. When the removed engine has been disassembled and rebuilt, it is placed back in stock for later use in another car.

In early 2014, Mario bought a race car, complete with engine. After its first 2014 race, the engine was removed and replaced. The engine that came with the car, "engine A," is rebuilt and placed in stock for later use.

All engines in Mario's stock except for engine A are rotatable spare parts. Engine A is not any type of spare part because it was acquired as part of a single unit of property.

Example 3. Use the same facts as **Example 2.** Each race includes several mandatory pit stops for tire changes. Old tires are routinely discarded after each use, even if a significant amount of tread remains. Mario's pit crew has a lot of new tires available, all of which were bought by Mario separately from any car. In addition, there are four previously used tires in slightly worn condition, also bought separately, that are available in case the pit crew has used all their new tires.

The new tires in Mario's stock are materials and supplies. In Mario's business, their useful life is far less than 12 months — actually, only a few hours — after being first used. **The set of previously used tires is a temporary spare part.** It cannot be classified as a **standby emergency spare part**, because it is subject to normal periodic replacement.

Example 4. Use the same facts as **Example 2.** The car Mario bought in 2014 came with a custom seat (seat A), which was built for the car. Seat A was not up to Mario's standards for his drivers' comfort and safety, so he immediately discarded it and had another one custom-built (seat B). Seat B was made specifically to fit that particular car and is not interchangeable with any other car in Mario's fleet.

Before seat B was installed in the car, Mario's team designed an even better, safer seat (seat C) that could be fabricated to fit the same car. Mario had seat C custom-built and installed on the 2014 car. Now that there was a better design available, Mario had no further use for seat B. It is kept in the pits in case Mario's driver has a fire or accident that damages seat C and makes it unusable or unsafe for the rest of the race. In that case, Mario's pit crew would quickly remove seat C and install seat B. However, Mario never plans to repair seat B. When it is fully worn out or obsolete, it would be just as economical to have a new, better seat fabricated.

Mario's tax professional knows that seat A came with the car and was part of the car's unit of property. Seat B would have been an improvement to that unit of property (a betterment), **had it been installed.** As it happened, **seat C becomes the improvement to the unit of property (the car) and seat B is a standby emergency spare part.**

Note. Improvements are discussed later.

Special Rule for Year of Deduction

Although rotatable and temporary spare parts are included within the term “materials and supplies,” deductions for their costs are not governed by the general rule provided earlier. Instead, the following rules apply.

- **The cost of a rotatable or temporary spare part** is generally deductible in the year the taxpayer disposes of the part.¹¹ A **change** to comply with this rule is a change of accounting method, which is automatic (DCN 188),¹² and it requires filing **Form 3115, *Application for Change in Accounting Method***.
- The cost of a **standby emergency spare part**, conversely, is governed by the general rules for materials and supplies.¹³

Spare parts are classified in examples 2, 3, and 4 as follows.

Example	Type of Spare Part	When Part Is Deductible
2	Rotatable spare parts	In year of use or disposal
3	Temporary spare parts	In year of use or disposal
4	Standby emergency spare parts	In year of use or disposal under the nonincidental materials and supplies rule

Special Optional Treatments

Under the new regulations, taxpayers who acquire or produce rotatable, temporary, and standby emergency spare parts may use one of two new optional accounting treatments for these items.

- An election to capitalize
- An optional accounting method that essentially allows a debit and credit method of accounting for placements and removals from service and refurbishments

Election to Capitalize. Treas. Reg. §1.162-3(d) provides for **an election to capitalize and depreciate** the rotatable, temporary, or standby emergency spare parts, rather than treat them as materials and supplies. To make the election, the taxpayer simply capitalizes and depreciates the amounts on its timely filed (including extensions) original tax return for the first year the parts are placed in service. This election, by itself, **does not require filing Form 3115**.

Note. The regulation is silent as to whether a separate statement should be filed with the return. It does not appear that such a statement is required.

¹¹ Treas. Reg. §1.162-3(a)(3).

¹² See Appendix B at the end of this chapter.

¹³ Treas. Regs. §§1.162-3(c)(3); 1.162-3(c)(1)(i); 1.162-3(a)(1).

Under this provision, a taxpayer may **not** elect to capitalize and depreciate an amount paid to acquire or produce any of the following.¹⁴

1. A rotatable, temporary, or standby emergency spare part that is intended to be used as a component of a unit of property which, itself, constitutes a material or supply that:
 - a. Has an economic useful life of 12 months or less,
 - b. Has an acquisition or production cost of \$200 or less, or
 - c. Otherwise may be treated as a material or supply according to specific published guidance in the Federal Register or the Internal Revenue Bulletin
2. A rotatable, temporary, or standby emergency spare part that is intended to be used as a component of a property that:
 - a. The taxpayer cannot or has not elected to capitalize and depreciate
 - b. Is property acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer; and
 - c. Is property not acquired as part of any single unit of tangible property
3. A rotatable or temporary spare part for which the taxpayer uses the optional accounting method (described later)

In the case of an S corporation or a partnership, the election is made at the entity level and not by the shareholders or partners. A taxpayer may make an election for each rotatable, temporary, or standby emergency spare part that qualifies for the election. Once made, the election may not be revoked without the consent of the IRS.¹⁵

Transitional Rule. A taxpayer may elect to apply this provision to amounts paid or incurred in taxable years beginning on or after January 1, 2012, and ending on or before September 19, 2013. If the taxpayer did not properly elect the treatment (by depreciating the property) on its original return, the taxpayer may make the election on an amended return filed on or before 180 days from the due date (including extensions) of the return for the applicable taxable year.

Application of Previous Temporary Regulations. A taxpayer could choose to apply Temp. Treas. Reg. §1.162-3T to amounts paid or incurred to acquire or produce property in taxable years beginning on or after January 1, 2012, and before January 1, 2014. These provisions generally allow the capitalization of materials and supplies (not limited to spare parts). However, to utilize the temporary regulation, the election had to be made on an original timely filed return, and there is no transitional relief provided.

Optional Accounting Method. As mentioned earlier, the costs to acquire or produce a rotatable or temporary (but not standby emergency¹⁶) spare part are generally deductible in the taxable year in which the disposition of the part occurs.¹⁷ **This optional accounting method uses adjustments to income as the spare parts are used, removed, and refurbished.** This allows the taxpayer to accelerate the timing of the deduction. If this optional method is used for spare parts, those parts are excluded from the de minimis safe harbor.

¹⁴ Treas. Reg. §1.162-3(d)(2).

¹⁵ Treas. Reg. §1.162-3(d)(3).

¹⁶ Standby emergency spare parts are deductible when first used or consumed in the taxpayer's business or operations. Treas. Regs. §§1.162-3(c)(3), 1.162-3(c)(1)(i), and 1.162-3(a)(1).

¹⁷ Treas. Reg. §1.162-3(a)(3).

Under the optional method, the taxpayer must apply the following rules to each rotatable or temporary spare part (referred to as “part,” in the following five rules) at the time of the initial installation, removal, repair, maintenance or improvement, reinstallation, and disposal of each part.¹⁸

1. **Initial installation.** Upon initial installation of the part, the cost of acquisition or production of the part is deducted in that taxable year. This gives the part an adjusted basis of zero.

Note. Although not stated in the regulation, the initial installation costs are also deductible in that taxable year.

2. **Removal.** If the part is subsequently removed from the initial or a subsequent installation, the taxpayer must:
 - a. Include in income the fair market value (FMV) of the part, and
 - b. Adjust the part’s basis by the FMV included in income and the amount paid (or incurred, for accrual taxpayers) to remove the part from the unit of property.
3. **Repair, maintenance, or improvement.** If any amounts are paid or incurred for repair, maintenance, or improvement of the part, these amounts are capitalized.
4. **Reinstallation.** In the taxable year that the taxpayer reinstalls a part, the taxpayer deducts the adjusted basis of the part and the cost of reinstallation. Following this deduction, the adjusted part’s basis is again reduced to zero.
5. **Disposal.** If there is any remaining adjusted basis at the time of the part’s disposal, that adjusted basis is deducted in the taxable year of the disposal.

The optional method is, to some extent, an all-or-nothing choice. If a taxpayer chooses to use the optional method for some rotatable or temporary spare parts, then they must use the optional method for **all** its pools of rotatable and temporary spare parts that meet both of the following criteria.

- The parts are used in the same trade or business.
- The taxpayer uses the optional method to account for them on its **books and records**.

If a taxpayer maintains a pool or multiple pools of rotatable and/or temporary spare parts but does not use the optional method **on its own internal books and accounting records** for **all** of those pools, then:

- The taxpayer may use the optional method for tax purposes for those pools that are carried on the books under the optional method; but
- The taxpayer may use the optional method for tax purposes for any pools **not** so carried on the books **only** if it also uses the optional method for **all** its pools of rotatable and temporary¹⁹ spare parts in the same trade or business.

¹⁸ Treas. Reg. §1.162-3(e)(1)-(2).

¹⁹ Treas. Reg. §1.162-3(e)(1)-(2) states “for all of its pools of **rotatable** spare parts” but for application of this phrase, the term “rotatable spare parts” includes “temporary spare parts.”

Example 5. Use the same facts as **Examples 2 and 3**. Mario has a pool of race car engines that are rotatable spare parts. He has four used tires that are temporary spare parts.

Additionally, he has two spare rebuilt alternators that he installs on his cars as needed. He sends the removed alternator out for rebuilding, and then it is returned to the pool. During races, Mario keeps these spare alternators in the pits to use if needed. Mario bought all of his alternators, including the ones now on his cars, separately (not with any car). All of Mario's alternators are also rotatable spare parts.

Mario likes the optional method because it lets him expense these items when they are used. When they are temporarily removed from service, only the remaining FMV is included in income.

On Mario's books, he accounts for the engines using the optional method. However, for simplicity, he accounts for all of the tires and alternators as nonincidental materials and supplies.

Mario tells Sophia, his accountant, that he wants to use the optional method for his engines and the four used tires. Sophia explains to Mario that, for his tax return, he can use the optional method for his pool of engines. She explains that if he wants to use that method for the pool of four tires, he must also use it for all his alternators. Mario tells Sophia that he would like to use the optional method for everything that he can.

The optional method for rotatable parts is a method of accounting under IRC §446(a). If the taxpayer has previously accounted for materials and supplies using a different method, **Form 3115** should be filed with the first return on which the optional method is used. Consent to this change (DCN 189) is automatic.

Transitional Provisions. This provision for the optional method of accounting for spare parts applies to taxable years beginning on or after January 1, 2014. A taxpayer may, however, choose to apply it to taxable years beginning on or after January 1, 2012.²⁰

Note. Unlike some of the other elective choices, a change to use this method does not appear to require that an amended return be filed within a shorter time than would otherwise be valid. It appears that the change can be made on an amended return filed at any time that the statute of limitations for the applicable year is open. However, this constitutes a change of accounting method²¹ that requires IRS consent before an amended return can be filed using the optional method. This consent is automatic when the taxpayer files **Form 3115**.

Alternatively, a taxpayer may use the similar optional method provided in Temp. Treas. Reg. §1.162-3T for taxable years beginning on or after January 1, 2012, and before January 1, 2014.²²

Note. If the election to capitalize is used, then accelerated depreciation methods under IRC §§168 and 179 may be available.

²⁰ Treas. Reg. §1.162-3(j)(2).

²¹ Treas. Reg. §1.162-3(i).

²² Treas. Reg. §1.162-3(j)(3).

UNITS OF PROPERTY

Regulations define unit of property as consisting of all the components of property that are functionally interdependent.²³ Special rules apply to what constitutes a unit of property based on the type of property and the taxpayer's use.

BUILDINGS

Building generally refers to any structure or edifice enclosing a space within its walls, and usually covered by a roof.²⁴ “Building” **does not include** the following.

- A structure that is essentially an item of machinery or equipment²⁵
- A structure that houses property used as an integral part of the following activities:²⁶
 - ♦ Manufacturing, production, or extraction
 - ♦ Transportation, communications, electrical energy, gas, water, or sewage disposal services

The use of the structure must be related to the use of the property closely enough that the structure can be expected to be replaced when the property it initially houses is replaced.

General Rule for Buildings

Generally, **each building and its structural components are a single unit of property**. Special rules, discussed later in this section, apply to condominiums, cooperatives, and leased buildings.

Structural Components. Structural components include the following parts of a building.²⁷

- Walls, partitions, floors, and ceilings
- Permanent coverings such as paneling or tiling
- Windows and doors
- All components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes, and ducts
- Plumbing and plumbing fixtures, such as sinks and bathtubs
- Electric wiring and lighting fixtures
- Chimneys
- Stairs, escalators, and elevators, including all components thereof
- Sprinkler systems
- Fire escapes
- Other components relating to the operation or maintenance of a building

²³ TD 9636, 2013-43 IRB 331.

²⁴ Treas. Reg. §§1.263(a)-3(e)(2)(i) and 1.48-1(e)(1).

²⁵ Ibid.

²⁶ PL 87-834 (Oct. 16, 1962). Treas. Reg. §1.263(a)-3(e)(2) defines a building with reference to Treas. Reg. §1.48-1(e)(1), which excludes property used with IRC §1245 property enumerated in (the prior) IRC §48(a)(1)(B)(i) as it existed at the time Treas. Reg. §1.48-1(e)(1) was written. That section, however, has since been fully rewritten, so this paragraph does not appear in the current IRC §48, and the practitioner must go to the original session law (PL 87-834) to find this listing of activities.

²⁷ Treas. Reg. §§1.263(a)-3(e)(2)(i) and 1.48-1(e)(2).

Structural components do not include machinery if the only reason for its installation is that the machinery is required to meet temperature or humidity requirements that are essential for the operation of other machinery or the processing of materials or foodstuffs.

Example 6. James owns a building; he uses the storefront for his business and he rents out the rest for office space. There is a single large water heater that serves the entire building. In 2014, the water heater wears out and Thomas replaces it with a new one.

The new water heater is **treated as a part of the building** and must be capitalized and depreciated in the same manner as the building (normally, 39-year nonresidential property).

For purposes of capitalization of an improvement,²⁸ improvement to the building includes amounts paid for an **improvement to the building structure or to any of the following building systems.**²⁹

- HVAC systems
- Plumbing systems
- Electrical systems
- All escalators
- All elevators
- Fire protection and alarm systems
- Security systems
- Gas distribution systems
- Certain structural components identified in the Federal Register or Internal Revenue Bulletin as being excepted from the building structure and specifically designated as building systems for purposes of these regulations

Cost Segregation. Not every fixture or component in a building is part of the building unit of property. To maximize tax savings, cost segregation may be advantageous. Cost segregation is the process of separating a single purchase into multiple depreciation classes. This allows the taxpayer to maximize shorter depreciation periods instead of keeping the entire cost of the purchase lumped into one asset with a longer depreciation period. It is important to draw a distinction between the components and systems of the building and assets that are IRC §1245 (generally, tangible personal property) or are certain IRC §1250 property (such as land improvements) that may be subject to shorter depreciation recovery periods and may qualify for bonus depreciation (when available). IRC §1245 property may also qualify for expensing under IRC §179.

²⁸ Treas. Reg. §§1.263(a)-3(e)(2)(ii) and 1.263(a)-3(d). Under the new regulations, to constitute an “improvement,” an expenditure must result in a betterment, a restoration, or an adaptation. These terms are specifically defined later in this chapter. (Treas. Reg. §§1.263(a)-3(j), 1.263(a)-3(k), and 1.263(a)-3(l)).

²⁹ Treas. Reg. §1.263(a)-3(e)(2)(ii)(B).

Example 7. Susie, Inc., owns a building that it uses in its retail business. The building contains two elevator banks, which consist of three elevators each. Susie, Inc., pays for a replacement of one of the cars to increase the weight capacity rating of one of the elevators. Together, the six elevators comprise a building system. The amount paid by Susie, Inc., for a replacement car is a betterment (discussed later) to the building.

Susie, Inc., must therefore capitalize and depreciate the cost of the new car over 39 years. However, if Susie, Inc., used a cost-segregation study to allocate the basis of the building to the various costs of the building structure, it would be able to deduct the remaining basis of the old car being replaced.³⁰

Observation. Cost segregation studies are becoming a popular and effective part of a property owner's annual tax saving strategy. From its beginnings as an IRS legal memorandum, the practice of employing cost-segregation studies in the accounting community has grown and evolved considerably.

Note. A good resource for information about cost segregation is the IRS Audit Technique Guide (ATG), which can be found at www.irs.gov/Businesses/Cost-Segregation-Audit-Techniques-Guide-Table-of-Contents. Industry-specific guidelines are provided for casinos, restaurants, retail industries, the biotech and pharmaceutical industry, and auto dealerships. Issue-specific guidelines for electrical distribution systems are also provided. However, information in the ATG concerning plant property (discussed later in this chapter) may be superseded by the new Treas. Reg. §1.263-3(e)(3)(ii).

Note. For illustrative purposes, some of the items that may be treated as IRC §§1245 and 1250 property for retail businesses are shown in Appendix A.

Example 8. Use the same facts as **Example 6**, except James's storefront portion of the building has a small kitchen in back which has its own water heater that serves the kitchen only. James uses the kitchen to prepare espresso, small cakes, and snacks that he provides to his business clients. The kitchen water heater wears out and James replaces it. If cost segregation is used, the water heater is not considered to be part of the building, but is instead treated as IRC §1245 property (see Appendix A at the end of this chapter). As such, it is depreciated separately from the building as 5-year property (or expensed under IRC §179).

Special Rules for Buildings

Special rules apply to the following types of buildings.

- Condominiums
- Cooperatives
- Leased buildings

Condominiums.³¹ The owner of a condominium in a building with multiple units treats the individual unit that they own as a single unit of property, together with the structural components that are part of the unit. For the condominium management association, however, the unit of property is the entire building and its building systems.

³⁰ Adapted from Treas. Reg. §1.263(a)-3(e)(6), Example 2.

³¹ Treas. Reg. §1.263(a)-3(e)(2)(iii).

Cooperatives.³² An amount is paid to improve a cooperative if it is paid to improve the portion of the building structure in which the taxpayer has possessory rights or the portion of any building system that is part of the building structure that is subject to the taxpayer's possessory rights. However, the cooperative housing corporation must apply the improvement rules to the entire building structure and any building systems.

Leased Buildings.³³ The lessee's unit of property cannot be larger than the portions leased. Therefore, the unit of property is described as follows.³⁴

- For a lease of the entire building, the unit of property is each building and its structural components and building systems that are subject to the lease.
- For a lease of a portion of a building, the unit of property is the portion of the building structure subject to the lease and the portion of any building system that is subject to the lease.

OTHER PROPERTY

General Rule for Property Other Than Buildings

Except for certain property noted later in this section, all of the components of real or personal property that are **functionally interdependent** comprise a **single unit of property**. Components of property are **functionally interdependent** if the placing in service of one component is dependent on placing another component in service by the taxpayer. Unlike an asset-by-asset determination (for class life and recovery period), "functional interdependence" depends on the use of the asset **in the hands of the particular taxpayer**.

Example 9. Amy is a stock car driver. She depreciates her race car using a 5-year MACRS recovery period. In 2014, she buys a new, high-performance carburetor that she installs in her race car. The old carburetor was still working properly and did not need repair, so the new one was a betterment (discussed later). The new carburetor would be useless to her if it were not attached to the fuel tank and the other systems of her car. Her car, not the carburetor, is the unit of property. This improvement to the car is depreciated in the same manner as the car (5-year property).

Example 10. Steve sells high-performance carburetors. In 2014, he buys an extra one to use as a display model. He has the new carburetor's working parts custom painted in various colors to show all of the parts and how they work. He keeps the display model on his countertop to advertise the carburetor to customers. This particular carburetor is not inventory, because it is not suitable for sale to customers. For Steve, the custom carburetor is a unit of property with a 5-year recovery period. It does not require any other component to do its job. If Steve also had a placard behind the carburetor describing its function, the carburetor and the placard, together, would comprise a single unit of property.

Special Rules for Property Other Than Buildings

Special rules apply to the following types of properties other than buildings.

- Plant property
- Network assets
- Leased property other than buildings
- Components **placed in service** in taxable years beginning **before January 1, 2014**

³² Treas. Reg. §1.263(a)-3(e)(2)(iv).

³³ Treas. Reg. §1.263(a)-3(e)(2)(v).

³⁴ Treas. Reg. §1.263(a)-3(e)(2)(v)(B).

Plant Property. Plant property is functionally interdependent machinery or equipment, other than network assets, used to perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or similar activities.³⁵ In the case of plant property used to perform an industrial process, the unit of property is further divided into smaller units comprised of each component or group of components that performs a **discrete** and **major** function or operation within the functionally interdependent machinery or equipment.³⁶

Network Assets. Network assets include such things as railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. Network assets include, for example, trunk and feeder lines, pole lines, and buried conduit. It does not include property that would be considered building structures or building systems nor does it include separate property that is adjacent to, but not part of, a network asset, such as bridges, culverts, or tunnels.

In the case of network assets, the functional interdependence standard described earlier is not determinative. What constitutes the unit of property is generally determined by the taxpayer's particular facts and circumstances, except as otherwise provided in published guidance in the Federal Register or in the Internal Revenue Bulletin.³⁷

Leased Property. For determination of the unit of property, when the taxpayer is the lessee of leased property other than buildings, the same general rule, plant property rule, and network asset rule apply as they would otherwise. The rule for components placed in service in a tax year beginning before 2014 (discussed next) also applies.

For leased property in the hands of the lessee, the unit of property may not be larger than the property subject to the lease.³⁸ For purposes of determining whether any expenditure made by the lessee constitutes an improvement (which must be capitalized), the unit of property includes previous lessee improvements.³⁹

Additional rules apply to:

- Lessee expenditures that are a substitute for rent,⁴⁰ and
- Lessor expenditures for an improvement if the lessee is the owner of the improvement.⁴¹

Components Placed in Service in a Tax Year Beginning before 2014. Because the new regulations require that all depreciation schedules be in compliance with the new standards and definitions beginning with taxable year 2014, the practitioner may face a quandary as to what to do with components that were placed into service in previous years but are now regarded as part of a single unit of property. If that single unit has a different MACRS class life than was previously used under the old rules for the components, the question arises as to which class life should now be used.

Treas. Reg. §1.263(a)-3(e)(5)(i) provides a simple solution to this problem for property other than buildings. If the taxpayer initially placed in service, prior to the applicability of these rules, a component (or group of components) of what would now be considered a unit of property, and properly treated the component as being in a different MACRS class than the unit of property, then that component (or group of components) must be treated as a separate unit of property. This also applies when the taxpayer has properly depreciated the component using a different method than the unit of property.

³⁵ Treas. Reg. §1.263(a)-3(e)(3)(ii)(A).

³⁶ Treas. Reg. §1.263(a)-3(e)(3)(ii)(B).

³⁷ Treas. Reg. §1.263(a)-3(e)(3)(iii).

³⁸ Treas. Reg. §1.263(a)-3(e)(3)(iv).

³⁹ Treas. Reg. §1.263(a)-3(f)(2).

⁴⁰ Treas. Reg. §1.61-8(c).

⁴¹ Treas. Reg. §1.263(a)-3(f)(2).

Example 11. Use the same facts as **Example 9**. Besides wanting her car to be fast, Amy wants it to sound great. She envisions driving the track with Beethoven's Seventh Symphony playing loud enough for all of the other drivers to hear. She also has a particularly dramatic idea for using the 1812 Overture near the end of the laps. Accordingly, she buys a couple of high fidelity home stereo speakers, hangs them in the rear of her car, and hooks them up to her car's sound system. She has no other use — business or otherwise — for these particular speakers.

If she does this in 2014, the speakers are part of the same unit of property as the car (as was the carburetor mentioned in **Example 9**), and she must depreciate them, with the car, as 5-year MACRS property. This is true even though she could keep the speakers when she sells the car.

However, if Amy had done this in 2013, the speakers would have been 7-year property when placed in service. The car would be on her depreciation schedule as 5-year property and the speakers as 7-year property. Even though, under the new regulations, the car and the two speakers would otherwise comprise a single unit of property, Treas. Reg. §1.263(a)-3(e)(5)(i) allows an exception. It **requires** that the car and the speakers retain their classification as two separate units of property — the car as 5-year property and the speakers as 7-year property. Consequently, Amy's accountant does not have to recalculate her depreciation schedule for this item.

SPECIAL RULES APPLICABLE TO ALL PROPERTIES

Although there are certain exceptions provided in Treas. Reg. §1.263(a)-3(d), **a taxpayer generally must capitalize all related amounts paid to improve a unit of property owned by the taxpayer.**⁴² This extends to amounts paid over a period of more than one taxable year. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed.⁴³

Certain Spare Parts

If the costs of rotatable spare parts, temporary spare parts, or standby emergency spare parts have been capitalized and are used as an improvement to a unit of property, then for purposes of applying the preceding requirement to capitalize improvements to the unit of property, the part is not a unit of property separate from the unit of property improved.⁴⁴

Note. Definitions of rotatable, temporary, and standby emergency spare parts and details of making the election to capitalize these expenditures are provided earlier in this chapter.

Changes in Subsequent Year

For the practitioner, a dilemma may arise for a unit of property that was depreciated under these regulations. In later years, either the taxpayer or the IRS may determine that a portion of what was treated as that unit of property belongs in a different MACRS class or should be depreciated using a different depreciation method. Treas. Reg. §1.263(a)-3(e)(5)(ii) provides that if, in any taxable year after a unit of property is initially placed in service by the taxpayer, the taxpayer or the IRS changes the treatment of that property (or any portion thereof) to a proper MACRS class or a proper depreciation method (for example, as a result of a cost segregation study or a change in the property's use), then the taxpayer must change the unit of property determination to be consistent with the change in treatment for depreciation purposes.

Thus, for example, if a portion of a unit of property is properly reclassified to a different MACRS class, then the reclassified portion of the property should be treated as a separate unit of property. If, on the other hand, properties previously depreciated in different classes are found to be part of the same unit of property, then they must be treated uniformly as the same unit of property.

⁴² Treas. Reg. §1.263(a)-3(d).

⁴³ Treas. Reg. §1.263(a)-3(g)(3).

⁴⁴ Treas. Reg. §1.263(a)-3(e)(4).

Example 12. Lily owns a flower shop. She bought the building in 2012 and immediately contracted an electrician to install more outlets for her ultraviolet greenhouse lights. Unfortunately, local building ordinances required her to bring the entire wiring and service up to current code. She had this done and capitalized the wiring cost on her 2012 federal tax return as 7-year property. She depreciated the rest of the building as 39-year nonresidential real property.

In 2014, Lily conducted a cost segregation study and determined that the wiring was a structural component of the building and therefore should have been depreciated in the same manner as the building unit of property (39 years). Due to this new information, Lily must change the building unit of property to include the wiring. The wiring must be depreciated as part of the building over 39 years.

Example 13. Use the same facts as **Example 12**, except Lily wanted more parking for customers and built a new lot shortly after acquiring the building. On her 2012 federal tax return, she had considered the new lot to be part of the building and depreciated it as 39-year property. Her 2014 cost segregation study, however, revealed it to be a land improvement⁴⁵ qualifying for a 15-year recovery period and the 150% declining balance (DB) method of depreciation. Accordingly, Lily changes her method of accounting for the parking lot to 15 years at 150% DB. She must now treat the parking lot as a unit of property separate from the building.

Note. In both of these examples, Lily would be required to file **Form 3115** and compute an IRC §481(a) adjustment. This is an automatic consent.

REPAIRS AND IMPROVEMENTS

ELECTION TO CAPITALIZE REPAIRS

Historically, amounts paid (or incurred, for accrual method taxpayers)⁴⁶ for repairs were deductible under IRC §162 as ordinary and necessary business expenses. This is reiterated in the new Treas. Reg. §1.162-4. However, a taxpayer may now elect to capitalize those expenses if they so choose.

Note. This might be useful, for example, for a new entity (or an individual with a new business) that has a loss in its first year and is expected to generate losses in future years. If the taxpayer would likely be unable to utilize the net operating loss, they may capitalize the repair expenses to avoid “throwing away” their deduction. The taxpayer converts the expense into basis, which can be utilized to reduce taxable income through additional depreciation expense in each year. Any remaining adjusted basis is then available to reduce gain or increase loss on an eventual sale or other disposition of the asset.

The election to capitalize repairs is available for taxable years beginning on or after January 1, 2014. The regulations also provide that a taxpayer may choose to apply Treas. Reg. §1.162-4 to certain taxable years beginning on or after January 1, 2012, but this choice is no longer available to most taxpayers. (See the “Transitional Provisions” section later in this chapter.)

If a taxpayer makes this election, it constitutes a change in accounting method that requires IRS consent.⁴⁷ Consent is likely automatic under DCN 184 (see Appendix B at the end of this chapter). Special rules apply to regulated taxpayers that must use a regulatory accounting method; for details, see Treas. Reg. §1.263(a)-3(m).

⁴⁵ See “Parking Lots” in Appendix A.

⁴⁶ Treas. Reg. §1.263(a)-3(b)(1).

⁴⁷ Treas. Reg. §1.162-4(b).

To be eligible to make the election to capitalize repairs and maintenance, the taxpayer must treat these amounts as capital expenditures on their books and records. Further, the election, if made, must be applied uniformly to all expenditures during that year for repairs and maintenance to tangible property that the taxpayer has treated on their books as capital expenditures.⁴⁸ However, this election does not apply to amounts paid for repairs or maintenance of rotatable or temporary spare parts to which the taxpayer applies the optional method of accounting (which is described earlier in this chapter) under Treas. Reg. §1.162-3(e).⁴⁹

The election is made by attaching a statement to a timely filed original federal tax return. Alternatively, taxpayers seeking to apply this provision to tax years beginning prior to January 1, 2014, may make the election on an amended return filed under the transition rule. In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group by the common parent, and the statement must include the names and taxpayer identification numbers of each member for which the election is made. In the case of an S corporation or a partnership, the election is made by the entity and not by the shareholders or partners.⁵⁰

The statement must be titled “Section 1-263(a)-3(n) Election” and include the taxpayer’s name, address, taxpayer identification number, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under Treas. Reg. §1.263(a)-3(n).

DETERMINING WHETHER ACTIVITY IS A REPAIR OR AN IMPROVEMENT

Under the new guidance, improvements, which must be capitalized, fall into three categories.⁵¹

1. Betterments
2. Restorations
3. Adaptations to a new or different use

Betterments⁵²

A taxpayer must capitalize an amount paid for a betterment to a unit of property as an improvement. A **betterment** to a unit of property is characterized as **meeting one of the following conditions**.

- Ameliorates a material condition or defect that either existed prior to the taxpayer’s acquisition of the unit of property or arose during the production of the unit of property, regardless of whether the taxpayer was aware of the condition or defect at the time of acquisition or production
- Is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component⁵³ to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property
- Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property

Buildings. Improvements to a building include a betterment to the building structure or any one of its building systems.⁵⁴

⁴⁸ Treas. Reg. §1.263(a)-3(n)(1).

⁴⁹ Treas. Reg. §1.263(a)-3(n)(3).

⁵⁰ Treas. Reg. §1.263(a)-3(n)(2).

⁵¹ Treas. Reg. §1.263(a)-3(d).

⁵² Treas. Reg. §1.263(a)-3(j).

⁵³ A major component is a part or combination of parts that performs a discrete and critical function in the operation of the unit of property. Treas. Reg. §1.263(a)-3(k)(6)(A).

⁵⁴ Treas. Reg. §1.263(a)-3(j)(2)(ii).

Unavailability of Replacement Parts. The regulation provides that if a taxpayer replaces a part of a **unit of property** (defined earlier in this chapter) that cannot reasonably be replaced with the same type of part (for example, because of technological advancements or product enhancements), the replacement of the part with an improved but comparable part does not, by itself, result in a betterment to the unit of property.⁵⁵ Generally, this type of replacement is a repair and is expensed as such on the tax return. However, if it otherwise meets the criteria for a betterment, a restoration, or an adaptation (discussed later), then it would be an improvement.

Example 14. Tony uses a computer in his business. It came with a 20-gigabyte (GB) hard drive, which is all he needs. In Tony's use of it, the hard drive is functionally interdependent with the rest of the computer, so it is part of the computer unit of property. One day, Tony's dog knocks his coffee cup onto the computer. The cup crashes, and so does the hard drive. Tony takes the unit to his computer technician, who tells Tony that they do not make 20 GB hard drives anymore, and the smallest he can buy is 100 GB. Tony buys that, and the technician installs it. For Tony, this is a repair. He expenses the repair on his tax return and continues depreciating the computer's original basis as before.

Appropriate Comparison.⁵⁶ If a taxpayer's expenditure for a unit of property is necessary due to normal wear and tear or damage to the unit of property that occurred during the taxpayer's use of the property, a determination must be made as to whether the expenditure constitutes a betterment to the unit of property. **This determination is made by comparing the condition of the property immediately after the expenditure with the condition of the property immediately prior to the circumstances necessitating the expenditure,** using the following guidance.

- If the expenditure is made to correct the effects of normal wear and tear to the unit of property that occurred during the taxpayer's use of the property, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear (whether the amounts paid were for maintenance or improvements). Or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property when placed in service by the taxpayer.
- If the expenditure is made to correct damage to a unit of property that occurred during the taxpayer's use of the property, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to the damage.

Example 15. Connie owns a building that she uses for her retail business. Over time, the waterproof membrane (top layer) on the roof of Connie's building begins to wear, and the retail premises experienced water seepage and leaks throughout. To eliminate the problem, a contractor recommends that Connie put a new rubber membrane on the worn membrane. Accordingly, Connie pays the contractor to add the new membrane. The new membrane is comparable to the worn membrane when it was originally placed in service by Connie.

The roof is part of the building structure. The condition necessitating the expenditure was the normal wear of Connie's roof while she was using it. Connie has not previously corrected the effects of normal wear and tear to the roof. Accordingly, Connie's accountant determines whether the cost is for a betterment by comparing the condition of the building structure after the expenditure with the condition of the structure when Connie placed the building into service.

Under these facts, the amount paid to add the new membrane to the roof does not result in a material addition or a material increase in the capacity of the building structure as compared to the condition of the structure when it was placed in service. Moreover, the new membrane is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure, as compared to the condition of the building structure when it was placed in service. Therefore, Connie is not required to treat the amount paid to add the new membrane as a betterment to the building under the rules that require capitalization of improvements.⁵⁷

⁵⁵ Treas. Reg. §1.263(a)-3(j)(2)(iii).

⁵⁶ Treas. Reg. §1.263(a)-3(j)(2)(iv).

⁵⁷ Adapted from Treas. Reg. §1.263(a)-3(j)(3), Example 13; Treas. Reg. §§1.263(a)-3(d)(1) and 1.263(a)-3(j).

Restorations⁵⁸

Treas. Reg. §1.263(a)-3(k) provides that a taxpayer must generally capitalize as an improvement an amount paid to restore a unit of property. This includes an amount paid to make good the exhaustion for which an allowance is or has been made.

An amount **restores a unit of property** only if it is for **one** of the following.

1. It is for the replacement of a component of a unit of property for which the taxpayer has properly deducted a loss, other than a casualty loss,⁵⁹ for that component. This does not apply if the unit of property has been fully depreciated and the loss is attributable only to the salvage value.
2. It is for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss from the sale or exchange of the component. This does not apply if the unit of property was fully depreciated and the loss is attributable only to the salvage value.
3. It is for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss or damage relating to an event that could have given rise to a deductible casualty loss,⁶⁰ regardless of whether such loss is claimed.⁶¹

The amount, if any, that must be capitalized as a restoration is limited to the adjusted basis of the single identifiable property, less any amounts paid for restoring the damage. Therefore, the practitioner must first determine the adjusted basis just prior to the casualty, then subtract the costs that constitute restorations under the other criteria of this section. The remaining amount, if any, is the maximum amount of the restoration under this criterion. If costs in excess of this amount are paid, they may still be subject to capitalization as betterments, restorations, or adaptations, if they meet the relevant criteria. If not, they are properly treated as repairs.

4. It returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use.

Example 16. Sebastian owns and operates a farm with several barns and outbuildings. One of the outbuildings was not used or maintained on a regular basis, and the outbuilding has fallen into a state of disrepair. The outbuilding previously was used for storage but can no longer be used for that purpose because it is not structurally sound. Sebastian decides to restore the outbuilding and pays to shore up the walls and replace the siding. The walls and siding are part of the building structure.

Sebastian must treat the amount paid to shore up the walls and replace the siding as a restoration of the building structure because they return the building structure to its ordinarily efficient operating condition. Therefore, Sebastian must capitalize the amount paid for shoring the walls and replacing the siding.⁶²

5. It results in the rebuilding of the unit of property to a like-new condition after the end of its class life **under the alternative depreciation system (ADS)**, regardless of whether ADS was actually used to depreciate the asset.⁶³ (If the unit of property is comprised of components with different class lives, then, for this purpose, the unit is deemed to have a class life equal to the longest component class life.⁶⁴)
6. It is for the replacement of a part or a combination of parts that comprise a **major component** or a **substantial structural part** (defined next) of a unit of property.

⁵⁸ Treas. Reg. §1.263(a)-3(k).

⁵⁹ Casualty losses to which this exception applies are those described in Treas. Reg. §1.165-7 and include most casualty losses.

⁶⁰ Deductible casualty losses are detailed in IRC §165.

⁶¹ Treas. Reg. §§1-263(a)-3(k)(1)(iii) and 1-263(a)-3(k)(4).

⁶² Adapted from Treas. Reg. §1.263(a)-3(k)(7), Example 6.

⁶³ Treas. Reg. §§1-263(a)-3(k)(1)(v) and 1-263(a)-3(i)(4). For the definition of "like-new condition," see Treas. Reg. §1-263(a)-3(k)(5).

⁶⁴ Treas. Reg. §1.263(a)-3(i)(4).

Major Component and Substantial Structural Part Defined.⁶⁵ When applying item 6 of the preceding restoration rules, the practitioner must make a determination whether an expenditure is for a major component or a substantial structural part. This determination must be made based on all the facts and circumstances, including both the qualitative and quantitative significance of the part or combination of parts in relation to the unit of property.

Major Component. A major component is a part or combination of parts that **perform a discrete and critical function in the operation of the unit of property**. An **incidental** component of the unit of property does not, by itself, constitute a major component, even though the component performs a discrete and critical function in the operation of the unit of property.⁶⁶

Example 17. Thomas, a fortune-teller, owns a building. He uses the storefront for his business and he rents out the rest for office space. Thomas's building has several water heaters, all of which serve the entire building, and he replaces only one of them. Although the water heater is part of the building unit of property, this would not necessarily constitute a restoration and, depending on the facts and circumstances, might not be an improvement requiring capitalization. Because it is only one of several water heaters, all of which perform the same function, it does not constitute a "major component" of the plumbing system. By itself, and given the environment (with several other water heaters), the water heater does not perform a critical and discrete function in the operation of the building unit of property. It therefore does not trigger this criterion of the restoration rule. If it does not otherwise meet the criteria of betterments, restorations, or adaptations, it is not an improvement — it is a repair.

If Thomas treated the retirement of the old water heater as a partial disposition of the building, deducting its adjusted basis on disposal, that would meet the restoration criteria, and he would be required to treat the new water heater as a restoration.

Substantial Structural Part. A substantial structural part is a part or combination of parts that comprise a large portion of the physical structure of the unit of property.⁶⁷

Application to Buildings.⁶⁸ For buildings, a replacement expenditure is for a major component or a substantial structural part of the building unit (including a building, condominium, cooperative, leased building, or leased portion of a building) if:

- The replacement includes a part or combination of parts that comprise a major component, or a significant portion of a major component, of the unit of property; or
- The replacement includes a part or combination of parts that comprise a large portion of the physical structure of the unit of property.

Example 18. Rivers, Inc., owns a building that it uses to operate its business. It pays to replace 30% of the wiring throughout the building with new wiring that meets building code requirements. The electrical system, including the wiring, is a building system.

All the wiring in the building comprises a major component because it performs a discrete and critical function in the operation of the electrical system. However, the portion of the wiring that was replaced is not a significant portion of the wiring major component, nor does it comprise a substantial structural part of the electrical system. Therefore, the replacement of 30% of the wiring is not the replacement of a major component or substantial structural part of the building. Consequently, Rivers, Inc., is not required to treat the amount paid as a restoration to the building under restoration criterion 6.⁶⁹

⁶⁵ Treas. Reg. §1.263(a)-3(k)(6).

⁶⁶ Treas. Reg. §1.263(a)-3(k)(6)(i)(A).

⁶⁷ Treas. Reg. §1.263(a)-3(k)(6)(i)(B).

⁶⁸ Treas. Reg. §1.263(a)-3(k)(6)(ii).

⁶⁹ Adapted from Treas. Reg. §1.263(a)-3(k)(7), Example 21.

Example 19. Sam owns a building in which he conducts a retail business. The retail building has three floors. It has men's and women's restrooms on two of the three floors. Sam decides to update all the restrooms by replacing the plumbing fixtures, including toilets and sinks, with modern style plumbing fixtures of similar quality and function. Sam does not replace the pipes connecting the fixtures to the building's plumbing system. The plumbing system, including the plumbing fixtures, is a building system.

All the toilets together perform a discrete and critical function in the operation of the plumbing system, as do all the sinks. Therefore, all the toilets comprise a major component of the plumbing system, and all the sinks comprise a major component of the plumbing system. Accordingly, Sam must treat the amount paid to replace all the toilets and sinks as a restoration of the building under restoration criterion 6. He must capitalize the amount paid as an improvement to the building.⁷⁰

Example 20. Use the same facts as **Example 19**, except that Sam does not update all the bathroom fixtures. Instead, Sam only pays to replace eight of the 20 sinks located in the various restrooms. The eight replaced sinks, by themselves, do not comprise a significant portion of a major component of the plumbing system, nor do they comprise a large portion of the physical structure of the plumbing system. Therefore, the replacement of the eight sinks does not constitute the replacement of a major component or substantial structural part of the building, and Sam is not required to treat the sinks as a restoration of the building under restoration criterion 6.⁷¹

Adaptations⁷²

Treas. Reg §1.263(a)-3(l) provides that a taxpayer must generally capitalize as an improvement an amount paid to **adapt a unit of property to a new or different use**. In general, it is an adaptation to a new or different use if the adapted unit of property is not consistent with the taxpayer's ordinary use of the unit at the time it was originally placed in service by the taxpayer.

If the unit of property is a building, a condominium, a cooperative, a leased building, or a leased portion of a building, then an adaptation exists if the building structure, or any of the building systems included in the unit of property, has been adapted to a new or different use.

Example 21. Debbie owns a parcel of land on which she previously operated a manufacturing facility. The land is the unit of property. During the course of Debbie's operation of the manufacturing facility, the land became contaminated with wastes from its manufacturing processes. Debbie discontinues manufacturing operations and decides to develop the property for residential housing. In anticipation of building residential property, she pays to remediate the contamination caused by her manufacturing process. In addition, she pays an amount to regrade the land so that it can be used for residential purposes.

Debbie's cleanup does not adapt the land to a new or different use, regardless of the extent to which the land was cleaned, because this cleanup merely returns the land to the condition it was in before it was contaminated. Therefore, Debbie is not required to capitalize the amount paid for the cleanup as an adaptation to a new or different use.

Debbie's tax professional compares the land right after the cleanup to when she first placed it in service using the "appropriate comparison" rule (explained earlier in the "Betterments" section). Because the land has now been put into the same condition as when it was first placed in service, Debbie's cleanup also does not result in a betterment.

⁷⁰ Adapted from Treas. Reg. §1.263(a)-3(k)(7), Example 22.

⁷¹ Adapted from Treas. Reg. §1.263(a)-3(k)(7), Example 23.

⁷² Treas. Reg §1.263(a)-3(l).

Furthermore, the cleanup does not meet any of the restoration criteria. (Criterion 4 does not apply because, even before the cleanup, the land was still functional for its intended use at the time it was placed in service.) Debbie will expense the cleanup costs as maintenance.

However, regrading the land so that it can be used for residential purposes adapts the land to a new or different use that is inconsistent with Debbie's intended ordinary use of the property at the time it was placed in service. Accordingly, the amounts paid to regrade the land are adaptations and must be capitalized as improvements to the land.⁷³

Example 22. Emily owns a building in which she operates a retail drug store. The store consists of a pharmacy for filling prescriptions and various departments where customers can purchase food, toiletries, home goods, school supplies, cards, over-the-counter medications, and other similar items.

Emily decides to create a walk-in medical clinic where nurse practitioners and physicians' assistants diagnose, treat, and write prescriptions for common illnesses and injuries, administer vaccinations, conduct screenings, and provide routine lab tests and services for common conditions. To create the clinic, Emily pays to reconfigure the pharmacy portion of the building. She incurs costs to build new walls and create an examination room, lab room, reception area, and waiting area. She installs additional plumbing, electrical wiring, and outlets to support the lab. She also acquires IRC §1245 (tangible personal) property, such as computers, furniture, and equipment necessary for the new clinic.

The conversion of part of the retail drug store building structure into a medical clinic adapts the building structure to a new and different use, because the use of the building structure to provide clinical medical services is not consistent with Emily's intended ordinary use of the building structure at the time it was placed in service. Similarly, the plumbing system and the electrical systems to support the new medical services are not consistent with Emily's intended ordinary use of these systems when they were placed in service. Therefore, Emily must capitalize the amounts paid for the conversion of the building structure, plumbing system, and electrical system as an improvement.

The new tangible personal property — the equipment, furniture, computers, and so on — are costs of acquiring new units of property. She must capitalize those costs, unless some of them qualify for the de minimis safe harbor or for treatment as materials and supplies (the safe harbor is discussed later in this chapter).⁷⁴ Tangible personal property also generally qualifies for expensing under IRC §179, subject to its limitations.⁷⁵

Example 23. Food For More, Inc., (FFM) owns a building in which it operates a grocery store. The grocery store includes various departments for fresh produce, frozen foods, fresh meats, dairy products, toiletries, and over-the-counter medicines. The grocery store also includes separate counters for deli meats, prepared foods, and baked goods, which are often made to order.

To better accommodate its customers' shopping needs, FFM decides to add a sushi bar where customers can order freshly prepared sushi from the counter to either take home or eat at the counter. To create the sushi bar, FFM adds a sushi counter and chairs, adds additional wiring and outlets to support the counter, and installs additional pipes and a sink to provide for the safe handling of the food. FFM also replaces the flooring and wall coverings in the sushi bar area to reflect more appropriate décor. The sushi counter and chairs are IRC §1245 (tangible personal) property, and FFM treats the amounts paid for those units of property as costs of acquiring new units of property.

⁷³ Adapted from Treas. Reg. §1.263(a)-3(l)(3), Example 4.

⁷⁴ Treas. Reg. §1.263(a)-2.

⁷⁵ Adapted from Treas. Reg. §1.263(a)-3(l)(3), Example 5.

The conversion of part of FFM's retail grocery into a sushi bar area does not adapt FFM's building structure, plumbing system, or electrical system to a new or different use. The sale of sushi is consistent with FFM's intended, ordinary use of the building structure and these systems in its grocery sales business, which includes selling food at various specialized counters. Accordingly, replacing the wall and floor finishes, adding wiring, and adding plumbing to create the sushi bar space do not improve the building unit of property under the adaptation rules and are not required to be capitalized under the rules for adaptations.

However, depending on the facts and circumstances (the amount of the new wiring, plumbing, etc., relative to that previously existing, as well as the effect on the functioning of the building and its systems), it still could constitute a betterment to the building. If so, it would require capitalization. Accordingly, FFM's tax professional must also evaluate the expenditure in light of the betterment and restoration rules in determining whether capitalization is ultimately required.⁷⁶

APPLICABLE FINANCIAL STATEMENT

The amounts of the de minimis safe harbor (defined later in this chapter) and certain other provisions of these new regulations depend on whether the taxpayer has an applicable financial statement (AFS). An AFS, shown here in descending priority, is one of the following.⁷⁷

- A statement that is required to be filed with the Securities and Exchange Commission (Form 10-K or the Annual Statement to Shareholders)
- A certified audited financial statement that is accompanied by the report of an independent CPA (or, in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for:
 - ♦ Credit purposes
 - ♦ Reporting to shareholders, partners, or similar persons
 - ♦ Any other substantial nontax purpose
- A financial statement (other than a tax return) required to be provided to the federal government, a state government, or any federal or state agency (other than the SEC or the IRS)

NEW SAFE HARBORS

DE MINIMIS SAFE HARBOR⁷⁸

A taxpayer electing to apply the de minimis safe harbor pursuant to Treas. Reg. §1.263(a)-1(f) is allowed to simply deduct, as ordinary and necessary business expenses under Treas. Reg. §1.162-1, certain costs to acquire, produce, or improve tangible property. This provision avoids the need to capitalize certain costs and to account for others as materials and supplies. A taxpayer that elects the de minimis safe harbor for certain amounts **must make the election for all amounts paid during the tax year for property, including materials and supplies, to which it applies.** The taxpayer must treat all such items uniformly under the election.

⁷⁶ Adapted from Treas. Reg. §1.263(a)-3(l)(3), Example 6.

⁷⁷ Treas. Reg. §1.263(a)-1(f)(4).

⁷⁸ Treas. Reg. §1.263(a)-1(f).

Accounting Procedures Required

In order to use this de minimis safe harbor, the taxpayer must have, at the beginning of the taxable year, accounting procedures that treat as an expense for **nontax** purposes:

1. Amounts paid for property costing less than a specified dollar amount; and/or
2. Amounts paid for property with an economic useful life⁷⁹ of 12 months or less.

The taxpayer must treat these amounts paid for property as expenses on the taxpayer's AFS. Taxpayers with an AFS must have **written** accounting procedures. If the taxpayer does not have an AFS, the taxpayer treats the amounts paid for the property as an expense on its books and records. Taxpayers without an AFS must have accounting procedures, but they are not required to be written. In the event that the taxpayer's accounting procedures contain both of the preceding provisions, the taxpayer must treat as de minimis amounts all expenses qualifying under either provision.⁸⁰

When a taxpayer's financial results are reported on an AFS for a group of entities, the group's AFS may be treated as the taxpayer's AFS. In this situation, the group's written accounting procedures may be treated as the taxpayer's written accounting procedures.⁸¹

De Minimis Amounts

The amount of the applicable de minimis expense limitation depends on whether the taxpayer has an AFS.

- Taxpayers with an AFS may treat amounts paid for property that do not exceed \$5,000 per invoice (or per item as substantiated by the invoice) as de minimis.
- Taxpayers **without an AFS** may treat amounts paid for qualifying property that do not exceed \$500 per invoice (or per item as substantiated by the invoice) as de minimis.

Although there is a per-item limitation, the de minimis safe harbor does not have an upper limit for the quantity or total cost of items that may be deducted.

Example 24. In 2014, Adrian, a calendar-year, cash-method taxpayer, purchases 10 printers at \$250 each and is invoiced for a total cost of \$2,500. Each printer is a unit of property. Adrian does not have an AFS. She has accounting procedures in place at the beginning of 2014 to expense amounts paid for property costing less than \$500, and she treats the amounts paid for the printers as an expense on her books and records. The amounts paid for the printers meet the requirements for the de minimis safe harbor.

If Adrian elects to apply the de minimis safe harbor in 2014, she may not capitalize any other amounts paid during 2014 that meet the criteria for the de minimis safe harbor. This includes all her costs to acquire, produce, or improve tangible property, as well as materials and supplies, as long as the price per item is less than \$500 as substantiated by the invoice. Instead of capitalizing the amounts paid, Adrian may deduct these amounts as ordinary and necessary business expenses in the taxable year that the amounts are paid, provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.⁸²

⁷⁹ As defined in Treas. Reg. §1.162-3(c)(3). The economic useful life is not necessarily inherent in the asset, but it is determined in the hands of the taxpayer. It depends largely on the use to which it is put by the particular taxpayer and how long it can be expected to be useful to them in their business.

⁸⁰ Treas. Reg. §1.263(a)-1(f)(3)(vii).

⁸¹ Treas. Reg. §1.263(a)-1(f)(3)(vi).

⁸² Adapted from Treas. Reg. §1.263(a)-1(f)(7), Example 1.

Making the Election

Once a taxpayer elects the de minimis safe harbor, the election is irrevocable. The election is made **annually** by attaching a statement to the taxpayer's timely filed original federal tax return (including extensions) for the tax year in which these amounts were paid (or incurred for accrual method taxpayers). The statement must be titled "Section 1.263(a)-1(f) De Minimis Safe Harbor Election" and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the de minimis safe harbor election under Treas. Reg. §1.263(a)-1(f).⁸³

Change of Accounting Method

A change in internal accounting procedures made to utilize the de minimis safe harbor does not constitute a change in accounting method. For example, if a taxpayer changes its written financial capitalization policy to treat amounts paid for property costing \$500 or less as an expense as of the beginning of 2015, the taxpayer is not required to file an application to change its method of accounting for its 2015 taxable year.⁸⁴

An election to utilize this de minimis safe harbor is specifically excluded from the changes requiring consent under Treas. Reg. §1.263(a)-1(g). It is not a change in accounting method; **it is a year-by-year election**. Therefore, a taxpayer electing this safe harbor for years beginning on or after January 1, 2014, is not required to file **Form 3115**.

Exceptions and Other Provisions

The de minimis safe harbor does not apply to the following.⁸⁵

- Amounts paid for land
- Property that is, or is intended to be, included in inventory
- Amounts paid for rotatable, temporary, and standby emergency spare parts (discussed earlier) that the taxpayer elects to capitalize and depreciate under Treas. Reg. §1.162-3(d)
- Rotatable and temporary spare parts that the taxpayer accounts for under the optional method of accounting for rotatable and temporary spare parts under Treas. Reg. §1.162-3(e)

Transaction and Additional Costs.⁸⁶ When determining whether an item meets the applicable de minimis cost, transaction and additional costs (e.g., delivery fees, installation costs, etc.) of acquiring or producing the property are not considered if they are not included on the same invoice as the property. If, however, these additional costs are listed on the same invoice, they must be included in the cost of the tangible property. If an invoice for multiple items of tangible property contains additional costs attributable to the various properties, these costs must be allocated in a reasonable manner (such as specific identification, pro rata allocation, or a weighted average method based upon the property's relative cost).

Note. To avoid exceeding the de minimis limit, taxpayers may arrange to have fees (such as delivery and installation costs) invoiced separately. This does not appear to violate the anti-abuse rule of Treas. Reg. §1.263(a)-1(f)(6).

⁸³ Treas. Reg. §1.263(a)-1(f)(5).

⁸⁴ Prologue to TD 9636, 2013-43 IRB 331.

⁸⁵ Treas. Reg. §1.263(a)-1(f)(2).

⁸⁶ Treas. Reg. §1.263(a)-1(f)(3).

Anti-Abuse Rule. Treas. Reg. §1.263(a)-1(f)(6) prohibits manipulating transactions by componentization of invoices (such as selling a \$10,000 car on three different invoices — one for the engine, one for the body and passenger compartment, and one for the suspension). The regulation allows the IRS to adjust manipulated transactions.

Sale or Disposition. Property to which the taxpayer has applied the de minimis safe harbor is not treated as a capital asset or as IRC §1231 business property when it is sold or otherwise disposed of.⁸⁷ The property has no basis. Therefore, all sales proceeds are treated as ordinary income.

Coordination with IRC §263A. IRC §263A requires the capitalization and inclusion in inventory of certain costs related to real or tangible personal property. For taxpayers subject to the provisions of §263A, amounts paid for property included under the de minimis safe harbor may be subject to capitalization if the amounts paid for the tangible property comprise the direct or allocable indirect costs of other property produced by the taxpayer or acquired for resale.

SAFE HARBOR FOR RECURRING ROUTINE MAINTENANCE COSTS

Treas. Reg. §1.263(a)-3(i) provides a new safe harbor under which routine and recurring costs to maintain property in serviceable condition are specifically excluded from the definition of an improvement and are deemed not to improve that unit of property.⁸⁸ Consequently, these expenses may escape capitalization and simply be expensed as ordinary and necessary business expenses. It may be necessary to file **Form 3115** to apply for a change of accounting method in order to use this safe harbor,⁸⁹ particularly if these amounts were previously capitalized. Consent to the change is automatic (see Appendix B, DCN 184), but an IRC §481(a) adjustment may be required. For this purpose, §481(a) requires that similar activities performed on the same property in previous years be treated uniformly.

Example 25. Adlai owns a motel. In 2014, he replaces the linoleum floor in a motel room. In 2009, he replaced the flooring and capitalized it on his 2009 return. For 2014, he uses the routine maintenance safe harbor to deduct his 2014 costs. Adlai must file **Form 3115** and compute a §481(a) adjustment, treating the same activity that was performed in 2009 as routine maintenance. Adlai removes the 2009 item from his depreciation schedule for the current and future years.

Unlike the other safe harbors provided in the new guidance, this routine maintenance safe harbor does not have limitations on amounts or require a specific written election to be filed. The taxpayer utilizes this safe harbor simply by not capitalizing the routine maintenance, taking the appropriate deduction on their tax return, and filing **Form 3115** if required.

Exceptions

The following are **excepted from the routine maintenance safe harbor**.⁹⁰

- Amounts paid for a **betterment** (defined earlier) to a unit of property
- Amounts paid for the replacement of a component of a unit of property for which the taxpayer has properly deducted a loss, other than a casualty loss,⁹¹ for that component
- Amounts paid for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component

⁸⁷ Treas. Reg. §1.263(a)-1(f)(3)(iii).

⁸⁸ Treas. Reg. §1.263(a)-3(i)(1).

⁸⁹ Treas. Reg. §1.263(a)-3(q).

⁹⁰ Treas. Reg. §1.263(a)-3(i)(3).

⁹¹ Casualty losses to which this exception applies are those described in Treas. Reg. §1.165-7 and include most casualty losses.

- Amounts paid for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss or damage relating to an event that could have given rise to a deductible casualty loss,⁹² regardless of whether such loss is claimed

Note. If the amount of this expense that must be regarded as a restoration is limited by item 3 of the criteria for restorations, then only the portion that must be regarded as a restoration under that item is excluded from treatment under the routine maintenance safe harbor.

- Amounts paid to return a unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use
- Amounts paid to adapt a unit of property to a new or different use (adaptations are defined earlier in this chapter)
- Amounts paid for repairs, maintenance, or improvement of network assets
- Amounts paid for repairs, maintenance, or improvement of rotatable and temporary spare parts to which the taxpayer applies the optional method of accounting for rotatable and temporary spare parts (discussed earlier)

Buildings

For a building that constitutes a unit of property, activities that may be expensed as routine maintenance include recurring activities that are necessary to keep the building structure and any building system in its ordinarily efficient operating condition.⁹³ Routine maintenance may include such things as inspection, cleaning, and testing of the building structure and systems, as well as replacement of damaged and worn parts with comparable and commercially available replacement parts.

Activities are considered routine maintenance only if they are of such a nature as to be **reasonably expected to be performed more than once during the 10-year period** that begins at the time the building is placed in service. If the taxpayer's expectation is reasonable, the IRS will not "look back" and hold the taxpayer's expectation unreasonable merely because the activity was not performed a second time. The taxpayer must be able to otherwise substantiate that their expectation was reasonable when the property was placed in service. In making a determination whether a taxpayer's expectation is reasonable, factors considered include the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical property.

Property Other than Buildings

For property other than buildings, routine maintenance activities are those designed to maintain the unit of property in its normally efficient operating condition. This includes the inspection, cleaning, and testing of components and the necessary replacement of damaged or worn parts with comparable and commercially available replacements.

To be considered routine, at the time the unit of property is placed in service, **the activity must be reasonably expected to be performed more than once during the class life** of the unit of property.⁹⁴ For this purpose, the class life is the ADS class life, regardless of whether ADS is actually used to depreciate the asset. Whether the maintenance is actually performed a second time during the class life is not critical, as long as the taxpayer had a reasonable expectation that it would be performed, given the same considerations and factors that would substantiate the reasonableness of the expectation regarding buildings.

⁹² Deductible casualty losses are detailed in IRC §165.

⁹³ Treas. Reg. §1.263(a)-3(i)(1)(i).

⁹⁴ Treas. Reg. §1.263(a)-3(i)(1)(ii).

If the facts and circumstances reflect that an activity is routine maintenance, even if performed after the end of the unit of property's recovery period, the cost may still be deducted as routine maintenance. The activity, in itself, does not necessarily constitute a restoration.

Except as specifically excluded from the safe harbor, amounts paid for routine maintenance include routine maintenance activities performed on rotatable and temporary spare parts.⁹⁵

Example 26. AirForLess, Inc., is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. The ADS class life for AirForLess's aircraft, including the engines, is 12 years. The aircraft maintenance manuals call for a variety of periodic maintenance visits at various intervals. One type of maintenance visit is an engine shop visit (ESV). AirForLess expects to perform this on its aircraft engines approximately every four years to keep its aircraft in its ordinarily efficient operating condition.

In 2014, AirForLess purchased a new aircraft, which is a single unit of property. In 2018, AirForLess will perform its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor that performs the ESV. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in AirForLess's maintenance program, the part is repaired or, if necessary, replaced with a comparable and commercially available replacement part. After the ESV, the engines are returned to AirForLess to be reinstalled on another aircraft or stored for later installation. None of the exceptions to routine maintenance apply to the costs of performing the ESVs.

The ESVs involve recurring activities that AirForLess expects as a result of its use of the aircraft. The ESVs keep the aircraft in its ordinarily efficient operating condition, and are maintenance activities expected to occur more than once during the 12-year class life of the aircraft. Consequently, AirForLess's ESVs are within the routine maintenance safe harbor. The ESV is not treated as an improvement to the aircraft and is not required to be capitalized.⁹⁶

Example 27. Use the same facts as **Example 26**, except that AirForLess pays for an ESV on one of the original aircraft engines after the end of the class life of the aircraft. Because this ESV involves the same routine maintenance activities previously performed on the engines, this ESV also is within the routine maintenance safe harbor. Accordingly, the amount paid for this ESV, even though performed after the class life of the aircraft, is considered routine maintenance that does not improve the aircraft. Therefore, this cost is not required to be capitalized.⁹⁷

SAFE HARBOR FOR BUILDINGS FOR QUALIFYING SMALL TAXPAYERS⁹⁸

A **qualifying small taxpayer** may elect to **not** apply the rules requiring capitalization of improvements⁹⁹ to eligible building property if both of the following conditions are met.

1. The eligible building had an **unadjusted basis** of \$1 million or less.
2. The **total** amount spent during the taxable year on repairs, maintenance, improvements, and similar activities on the building **does not exceed the lesser of \$10,000 or 2% of the unadjusted basis** of the building.

The safe harbor can be used for multiple buildings owned or leased by the taxpayer as long as the above two requirements are satisfied.

⁹⁵ Treas. Reg. §1.263(a)-3(i)(2).

⁹⁶ Adapted from Treas. Reg. §1.263(a)-3(i)(6), Example 1.

⁹⁷ Adapted from Treas. Reg. §1.263(a)-3(i)(6), Example 2.

⁹⁸ Treas. Reg. §1.263(a)-3(h).

⁹⁹ See Treas. Reg. §§1.263(a)-3(d) and §1.263(a)-3(f).

However, if amounts paid during the tax year exceed the \$10,000 or 2% limit for an eligible building, the safe harbor is not available for that building.¹⁰⁰ The election is made on an annual basis by attaching a statement to a timely filed return, including extensions. The attached statement must include a description of each building within the election.

These are all-or-nothing limits. If total expenses for a building exceed the preceding limits, no portion of the expenses is subject to this safe harbor. However, the other safe harbors (discussed earlier) may still be available for that building. In calculating the total amount spent during the tax year for repairs, maintenance, improvements, and similar activities (item 2), it is necessary for the taxpayer to include expenses that were not capitalized due to use of the other safe harbors. This includes the de minimis safe harbor and the routine maintenance or recurring activities safe harbor.

Qualifying Small Taxpayer

For purposes of the safe harbor for buildings, a qualifying small taxpayer is a taxpayer whose **average annual gross receipts for the three preceding tax years do not exceed \$10 million.**¹⁰¹ Gross receipts for short years must be annualized. If the taxpayer was in existence for less than three years, the average is determined over those years that the taxpayer (and its predecessor, if any) were in existence.

Gross Receipts. Gross receipts, for purposes of determining whether a taxpayer is a qualifying small taxpayer, may be different from the amounts that were routinely reported as gross receipts on the taxpayer's Schedule C, *Profit or Loss From Business*, or entity return. For this purpose, gross receipts includes the following amounts.¹⁰²

- Total sales (net of returns and allowances) and amounts received for services
- Sales tax collected, if state or local law imposes the tax on the selling taxpayer (If state or local law imposes the sales tax on the purchaser, then sales taxes collected at the point of sale should be excluded from the total sales figure.)
- All investment and other incidental income, whether or not derived in the course of the taxpayer's trade or business (These amounts include interest, tax-exempt interest, original issue discount, dividends, rents, royalties, and annuities.)
- Net capital or ordinary gain or loss from the sale of assets or property

Unadjusted Basis

For purposes of this safe harbor provision, the unadjusted basis of property owned is generally determined as it is for other tax purposes. Guidance is provided for certain unusual circumstances in Treas. Reg. §1.263(a)-3(h)(5).

In the case of a leased building, the unadjusted basis of the property leased to the taxpayer is **the total amount of undiscounted rent paid and expected to be paid for the entire term of the lease.** This includes rents due for all renewal periods if all the facts and circumstances that were present at the lease's inception indicate a reasonable expectancy of renewal.¹⁰³

¹⁰⁰. Treas. Reg. §1.263(a)-3(h)(8).

¹⁰¹. Treas. Reg. §1.263(a)-3(h)(3).

¹⁰². For further detail, see Treas. Reg. §1.263(a)-3(h)(3)(iv).

¹⁰³. Treas. Reg. §1.263(a)-3(h)(5)(ii). For significant factors indicating whether there exists a reasonable expectancy of lease renewal, see Treas. Reg. §1.263(a)-4(f)(5)(ii).

Electing the Safe Harbor¹⁰⁴

A taxpayer annually elects the safe harbor for buildings by attaching a statement to their original, timely filed (including extensions) federal tax return for the taxable year that the amounts were paid (or incurred, if the taxpayer uses the accrual method) for qualifying repairs, maintenance, improvements, and similar activities. For an S corporation or a partnership, the election is made by the entity and not by the shareholders/partners. Once made, a taxpayer may not revoke this safe harbor election for that year.

The statement must be titled “Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers.” The statement must include:

1. The taxpayer’s name, address, and taxpayer identification number; and
2. A description of each eligible building property to which the taxpayer is applying the election.

The taxpayer then deducts the expenses to which the safe harbor applies on their tax return, either as ordinary and necessary business expenses under IRC §162 or as expenses for the production of income under IRC §212, as applicable. It is not necessary to file **Form 3115** to make the election, because it is not a change in accounting method.

Example 28. Bart is a qualifying small taxpayer. He owns two rental properties, building M and building N. Both buildings are multi-family residential buildings. In 2014, each property has an unadjusted basis of \$300,000. Because building M and building N each have an unadjusted basis of \$1 million or less, they each constitute eligible building property in 2014. In 2014, Bart pays \$5,000 for repairs, maintenance, improvements, and similar activities performed on building M. Bart also pays \$7,000 for repairs, maintenance, improvements, and similar activities performed on building N in 2014.

The \$5,000 paid by Bart for repairs, maintenance, improvements, and similar activities on building M does not exceed the lesser of \$10,000 or \$6,000 (2% of the building’s unadjusted basis of \$300,000). Therefore, for 2014, Bart may elect to not apply the rule regarding capitalization of improvements¹⁰⁵ to the amounts he paid. If Bart properly makes the safe harbor election for building M and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on Bart’s trade or business,¹⁰⁶ he may deduct these amounts as ordinary and necessary business expenses.

The \$7,000 paid by Bart for repairs, maintenance, improvements, and similar activities on building N exceeds \$6,000 (2% of the building’s unadjusted basis of \$300,000). Therefore, Bart may not apply the safe harbor to the total paid. Instead, Bart must apply the general improvement rules for betterments, restorations, and adaptations to determine which amounts paid for work on building N are for improvements (must be capitalized) and which amounts are for repair and maintenance (may be expensed).¹⁰⁷

¹⁰⁴. Treas. Reg. §1.263(a)-3(h)(6) and (7).

¹⁰⁵. Treas. Reg. §1.263(a)-3(d).

¹⁰⁶. Rules for ordinary and necessary business expenses are found in Treas. Reg. §1.162-1.

¹⁰⁷. Adapted from Treas. Reg. §1.263(a)-3(h)(10), Example 3.

CHANGE OF ACCOUNTING METHOD

Generally, changes to comply with the new regulations constitute a change of accounting method that requires the filing of **Form 3115**.¹⁰⁸ Many of the accounting method changes required to utilize TD 9636 qualify for automatic consent. For a partial list of changes for which consent is automatic under Rev. Proc. 2014-16 and designated automatic accounting method change numbers (DCN), see **Appendix B** at the end of this chapter. Other automatic changes are detailed in Rev. Procs. 2014-16 and 2014-17. Rev. Proc. 2014-16 also provides a simplified method of filing **Form 3115** for qualifying small taxpayers.

Some experts suggest that, to be safe, all businesses that acquire or maintain tangible property (whether for use in the business, as inventory held for sale, or otherwise) must now file **Form 3115** with their next returns to indicate awareness of, and compliance with, the new regulations.¹⁰⁹ If an IRC §481(a) adjustment is needed as a result of a change in accounting method to prevent omission or duplication of an item of income or expense, the adjustment is made in part IV of **Form 3115**.

Note. Special procedures apply for submitting the separate **Form 3115** to the IRS in Ogden, Utah, rather than the IRS National Office. There are also simplified completion requirements if the taxpayer has average annual gross receipts for the three preceding tax years of \$10 million or less.

Many **Forms 3115** filed under the new regulations may require no IRC §481(a) adjustment. However, for tangible personal property that is still carried on the books (and so affects the current return), it is important to understand that the reach of §481(a) goes back to when that property was first placed in service. Further, use of the regulations' new improvement standards is a **method of accounting**. If a taxpayer's previous accounting procedures or treatments of property on tax returns differ materially from those under the new regulations (e.g., identification of improvements, timing of deductions, etc.), a change to comply with the new regulations requires filing **Form 3115**. The identification of improvements under the new regulations extends to items capitalized or expensed on previous returns if those items are still within their recovery periods. Any adjustments are made as §481(a) adjustments on **Form 3115** rather than by amending the earlier years' returns.

Example 29. Sally owns a house that is rental property (27.5-year MACRS property). In 2006, she replaced the central air conditioner compressor and deducted the cost as a repair. Under the new regulations, the compressor is part of the building, and the replacement of the compressor is a restoration. Sally must file **Form 3115** and calculate a §481(a) adjustment, recapturing the amount expensed in 2006 and treating the compressor as 27.5-year depreciable property from the time it was first placed in service to the present. She should not file Form 1040X, *Amended U.S. Individual Income Tax Return*, for 2006 or the other intervening years for this change.

It is important for businesses to review their written accounting policies and their fixed asset register or depreciation schedules. This is necessary to determine whether the business is in compliance with the new regulations or whether a change of accounting method is required.

¹⁰⁸. Treas. Reg. §§ 1.162-3(i), 1.263(a)-3(q), et al.

¹⁰⁹. See, e.g., *Forms 3115 May Be Needed to Adopt Tangible Property Regulations*. Abdoo, Kate, and Peterson, Kari. Mar. 19, 2014. McGladrey LLP. [http://mcgladrey.com/content/mcgladrey/en_US/what-we-do/services/tax/forms-3115-may-be-needed-to-adopt-tangible-property-regulations.html] Accessed on Apr. 30, 2014; and *Treasury Department Suggests All Taxpayers File 3115 to Comply with Tangible Property Regulations*. Walsh, Brendan J. Feb. 19, 2014. Clark Schaefer Hackett, CPAs & Business Consultants. [www.cshco.com/treasury-department-suggests-taxpayers-file-3115-comply-tangible-property-regulations] Accessed on Apr. 30, 2014.

CORRECTING DEPRECIATION SCHEDULES AND PRIOR ACCOUNTING ERRORS

Form 3115, which allows a **cumulative** adjustment under IRC §481(a), may provide a much easier vehicle to bring depreciation schedules and expense accounts into compliance than amending prior year returns.¹¹⁰ Additionally, IRC §481(a) can effectively open years for which the statute of limitations passed for purposes of obtaining a refund.

Filing **Form 3115** sometimes requires the taxpayer to pay a user fee, but no user fees are required when the change is one that qualifies for automatic consent. Some of the automatic changes that relate to the final (and also to the temporary) tangible property regulations are shown in Appendix B. Over 180 automatic changes are detailed in Rev. Proc. 2011-14.¹¹¹ Rev. Proc. 2014-16 supplements Rev. Proc. 2011-14 with regard to certain changes under these new property regulations. Rev. Proc. 2011-14 also provides for certain cut-off basis changes,¹¹² which are changes that accept the past accounting and only affect current and future years. For these changes, an IRC §481(a) adjustment is neither required nor permitted.

Failure to File Form 3115

It is anticipated that many taxpayers, particularly smaller businesses, will be unaware of the need to file **Form 3115** or will otherwise fail to do so. The effects of complying with the new regulations but failing to file **Form 3115**, if required, are as follows.

1. This constitutes **an unauthorized change of accounting method**.
2. On examination, the IRS can change the taxpayer's method of accounting to one that it believes most clearly reflects income. In so doing, the IRS may impose an IRC §481(a) adjustment encompassing prior years, without regard to a statute of limitations.¹¹³
3. Any §481(a) adjustment is imposed in one year rather than over a 4-year period as allowed for a voluntary positive §481(a) adjustment.
4. If the examination results in an increase in tax, the failure-to-pay penalty may apply to the earlier understatement of tax. Accuracy-related and other penalties may also be imposed.

Note. Section 2.09 of Rev. Proc. 2011-14 provides that “Any otherwise applicable penalty, addition to the tax, or additional amount for the failure of a taxpayer to change its method of accounting (for example, the accuracy-related penalty under §6662 or the fraud penalty under §6663) may be imposed if the taxpayer does not timely file a request to change a method of accounting. See §446(f). Additionally, the taxpayer's return preparer may also be subject to the preparer penalty under §6694. However, penalties, additions to the tax, or additional amounts will not be imposed when a taxpayer changes from an impermissible method of accounting to a permissible one by complying with all applicable provisions of this revenue procedure.”

^{110.} Generally, an amended return may not be used to correct depreciation errors. Form 3115 must be used.

^{111.} Rev. Proc. 2011-14, 2011-4 IRB 330.

^{112.} When a change in method of accounting is made on a cut-off basis, in general, only the items arising on or after the beginning of the year of change (or other operative date) are accounted for under the new method of accounting. Any items arising before the year of change (or other operative date) continue to be accounted for under the taxpayer's former method of accounting. Rev. Proc. 2011-14, 2011-4 IRB 330.

^{113.} IRC §§481, 1311–1314; and *Graff Chevrolet Co. v. Campbell*, 343 F.2d 568 (5th Cir. 1965).

Observation. An ethical dilemma may arise if a practitioner determines that **Form 3115** should be filed but the client does not want to go to the extra expense. Seemingly, this puts the practitioner in a difficult situation, because they may not disregard the rules and regulations but also should not perform chargeable work other than that ordered by the client. In extreme cases, the practitioner may choose to decline the job. Another ethical course of action for the practitioner might be as follows.

- Inform the client of the need for **Form 3115** and the possible consequences of failing to file it.
- Document in the work papers that the client was so informed and the client's decision.
- Perform the other accounting and tax services in strict compliance with the regulations, relying on the exception from penalty provided by section 2.09 of Rev. Proc. 2011-14.

Late Partial Disposition Loss Election

Rev. Proc. 2014-17 allows a taxpayer to claim a loss for a late partial disposition accounting method change (such as for a taxpayer who replaced and capitalized an asset but did not claim a disposition loss on the asset). The resulting loss, even if it arose from a partial disposition several years earlier, can be claimed on the timely filed (or extended) 2013 return with an automatic consent accounting method change. The election is allowable for any tax year beginning on or after January 1, 2012 and beginning before January 1, 2014, but the automatic consent accounting method change via **Form 3115** must be made with a timely filed return (including extensions).

Observation. The partial disposition loss election may be particularly useful to taxpayers with real estate that have capitalized replacements (such as roofs) to the real estate when the old component was removed. The loss deduction, which equals the old component's remaining undepreciated basis, can be claimed in 2013.

APPLICABILITY DATES

In general, the final regulations of TD 9636,¹¹⁴ issued September 13, 2013, are effective as of September 19, 2013, and apply to taxable years beginning on or after January 1, 2014. However, certain provisions of the regulations only apply to amounts **paid (or incurred, if the taxpayer uses the accrual method)**¹¹⁵ in taxable years beginning on or after January 1, 2014. For example, the de minimis safe harbor election under Treas. Reg. §1.263(a)-1(f) only applies to amounts paid or incurred for tangible property after January 1, 2014, **and** for taxable years beginning on or after January 1, 2014.

¹¹⁴ TD 9636, 2013-43 IRB 331.

¹¹⁵ Treas. Reg. §1.263(a)-1(c)(1).

TRANSITIONAL PROVISIONS

A taxpayer may choose to have these new regulations apply retroactively to taxable years beginning on or after January 1, 2012, and ending on or before September 19, 2013. For these taxpayers, certain provisions apply only to amounts actually paid or incurred on or after the beginning of the taxable year.¹¹⁶

Although certain provisions of the new regulations require that the taxpayer make an election with a timely filed return, the regulations also provided some transitional relief to enable early application of the regulations.¹¹⁷ Unfortunately, this transitional relief is no longer available to most taxpayers.

The TD 9636 provision for the election to capitalize spare parts¹¹⁸ is an election made without a statement. **The following provisions of TD 9636 require that a written election statement be filed with the original return.**

- Election to capitalize repairs¹¹⁹
- Safe harbor for buildings for qualifying small taxpayer¹²⁰
- De minimis safe harbor for capital assets, materials, and supplies¹²¹

Note. For a calendar-year taxpayer, the transitional provisions for the preceding items may no longer be applied to tax year 2012 and do not apply to calendar year 2013. An entity whose taxable year ended August 31, 2013, with a 6-month extension, has until November 12, 2014, to make the election under the transitional rule. An individual taxpayer filing Form 1040 with a taxable year ended August 31, 2013, has until December 12, 2014.

To apply these provisions to years beginning on or after January 1, 2012, and before January 1, 2014, an amended return must be filed, with the required election statement, on or before 180 days from the due date, including extensions, of the taxpayer's federal tax return for the applicable year. In other circumstances, making a late election generally requires the prior consent of the IRS Commissioner, which may be obtained through a private letter ruling. A late election cannot typically be made by filing an amended tax return before obtaining IRS consent or by merely filing **Form 3115, Application for Change in Accounting Method**.¹²²

The following provisions **do not require** making a year-by-year election.

- Routine maintenance safe harbor¹²³
- Optional accounting method for certain spare parts¹²⁴

For these provisions, early application is not limited by the 180-day period for amendment. When changing from the method used on previous years' federal tax returns, it is necessary to file **Form 3115** and obtain consent (which may be automatic) to change the accounting method.

¹¹⁶. Treas. Reg. §1.263(a)-1(h)(2).

¹¹⁷. TD 9636, 2013-43 IRB 331; and Treas. Reg. §1.263(a)-1(h)(2)(ii).

¹¹⁸. Treas. Reg. §1.162-3(j)(2)(ii).

¹¹⁹. Treas. Reg. §1.263(a)-3(r)(2).

¹²⁰. Ibid. This applies only to amounts paid or incurred during the taxable year.

¹²¹. Treas. Reg. §§1.263(a)-1(h)(2) and 1.263(a)-1(f)(5). This applies only to amounts paid or incurred during the taxable year.

¹²². Treas. Reg. §1.263(a)-3(h)(6).

¹²³. Treas. Reg. §1.263(a)-3(r)(2).

¹²⁴. Treas. Reg. §1.162-3(j)(2)(i). This applies only to amounts paid or incurred during the taxable year.

Example 30. Acme Corporation, a calendar-year taxpayer, wants to apply the new regulations to taxable years beginning on or after January 1, 2012. It also seeks to apply the de minimis provisions of Treas. Reg. §1.263(a)-1(f). However, as stated in the regulation, the de minimis provision may be invoked only by an election made with the timely filed original federal tax return for the applicable taxable year. In this case, that would be before the regulations were finalized. For taxpayers seeking to apply the provisions to taxable years beginning on or after January 1, 2012, and ending on or before September 19, 2013, the transitional rule allows them to make the election. This is done by filing an amended federal tax return for the applicable year within 180 days from the original return due date, including extensions.

Acme's extended due date for its 2012 return was September 15, 2013. It cannot now comply with the de minimis election rules for 2012. To do so, the amended 2012 return would have been due by March 14, 2014.

Acme's extended due date for its 2013 return is September 15, 2014. However, the transitional rule only applies to years **ending on or before September 19, 2013**. Acme's 2013 year ended December 31, 2013. Acme cannot now use the de minimis provisions for either their 2012 or 2013 returns.

Alternatively, for taxable years beginning on or after January 1, 2012, and before January 1, 2014, a taxpayer may generally apply the provisions of the temporary regulations contained in TD 9564.¹²⁵

Note. For information about TD 9564, see the 2012 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues. This chapter can be found at www.taxschool.illinois.edu/taxbookarchive/.

¹²⁵. Treas. Reg. §§1.162-3(j)(3), 1.162-4(c)(3), et al.

APPENDIX A — IRS COST SEGREGATION ATG

CHAPTER 7.3: INDUSTRY SPECIFIC GUIDANCE — RETAIL INDUSTRIES¹²⁶

Asset	Description	Property Type	Category	Recovery Period
Awnings & Canopies	Readily removable overhang or covering, often of canvas or plastic, used to provide shade or cover over a storefront, window, or door; or used inside a structure to identify a particular department or selling area. Examples include applications over an exterior door or window, or attached to interior walls or suspended from ceilings for bakery, deli, floral, meat, or produce departments. Also includes canopies designed to protect customers and gasoline fueling equipment from weather conditions and to act as advertising displays that are anchored with bolts and are not attached to buildings or other structures. Does not include canopies that are an integral part of a building's structural shell, such as in the casino industry, or over docks. See also Concrete Foundations & Footings and Loading Docks .	1245	57.0 Distributive Trades and Services	5 years
Beverage Equipment	Equipment for storage and preparation of beverages and beverage delivery systems. Beverage equipment includes the refrigerators, coolers, dispensing systems, and the dedicated electrical, tubing or piping for such equipment. The dispensing system may be gravity, pump or gas driven. See also Refrigerated Structures .	1245	57.0 Distributive Trades and Services	5 years
Ceilings	Includes all interior ceilings regardless of finish or décor; e.g. drywall or plaster ceilings, acoustic ceilings, suspended ceilings (including hangers, frames, grids and tiles or panels), decorative metal or tin finishes, plastic panels, decorative panels, etc. See also Awnings & Canopies, Millwork — Decorative, and Millwork — General Building or Structural .	1250	Building or Building Component	39 years
Computers	Processors (CPU), direct access storage device (DASD), tape drives, desktop and laptop computers, CRT, terminals, monitors, printers, and other peripheral equipment. Excludes Point of Sale (POS) systems and computers that are an integral part of other equipment (e.g., fire detection, heating, cooling, or energy management systems, etc.).	1245	00.12 Information Systems	5 years

¹²⁶. *Cost Segregation ATG — Chapter 7.3*. [www.irs.gov/Businesses/Cost-Segregation-ATG-Chapter-7-3-Industry-Specific-Guidance-Retail-Industries] Accessed on Jun. 5, 2014.

Asset	Description	Property Type	Category	Recovery Period
Concrete Foundations & Footings	Includes formwork, reinforcement, concrete block, and pre-cast or cast-in-place work related to foundations and footings necessary for the proper setting of the building.	1250	Building or Building Component	39 years
	Foundations or footings for signs, light poles, and other land improvements (except buildings).	1250	00.3 Land Improvements	15 years
	The supporting concrete footings used to anchor gasoline pump canopies are inherently permanent structures and are classified as land improvements.	1250	57.1 Distributive Trades and Services	15 years
Data Handling Equipment	Includes adding and accounting machines, calculators, copiers, and duplicating machines. Excludes computers and computer peripheral equipment, see Computers .	1245	00.13 Data Handling Equipment, except Computers	5 years
Doors	Interior and exterior doors, regardless of decoration, including but not limited to, double opening doors, overhead doors, revolving doors, mall entrance security gates, roll-up or sliding wire mesh or steel grills and gates, and door hardware (such as doorknobs, closers, kick plates, hinges, locks, automatic openers, etc.).	1250	Building or Building Component	39 years
	Special lightweight, double action doors installed to prevent accidents in a heavily trafficked area. For example, flexible doors, or clear or strip curtains used between stock and selling areas.	1245	57.0 Distributive Trades and Services	5 years
Doors — Air Curtains	Air doors or curtains are air systems located above doors and windows that circulate air to stabilize environments and save energy by minimizing the heated/air conditioned air loss through open doorways and windows. They also effectively repel flying insects, dust, and pollutants.	1250	Building or Building Component	39 years
Drive-Through Equipment	Drive-through equipment includes order taking, merchandise delivery, and payment processing systems whether mechanical or electronic. Excludes building elements such as doors, bays, or windows. See also Walls — Exterior and Windows for drive-through bays and windows .	1245	57.0 Distributive Trades and Services	5 years

2014 Workbook

Asset	Description	Property Type	Category	Recovery Period
Electrical	Includes all components of the building electrical system used in the operation or maintenance of the building or necessary to provide general building services such as electrical outlets of general applicability and accessibility, lighting, heating, ventilation, air conditioning, and electrical wiring.	1250	Building or Building Component	39 years
	Special electrical connections which are necessary to and used directly with a specific item of machinery or equipment or connections between specific items of individual machinery or equipment; such as dedicated electrical outlets, wiring, conduit, and circuit breakers by which machinery and equipment is connected to the electrical distribution system. Does not include electrical outlets of general applicability and accessibility. See Chapter 5 of the Cost Segregation Audit Techniques Guide for allocation examples.	1245	57.0 Distributive Trades and Services	5 years
Elevators and Escalators	Elevators and escalators, which include handrails and smoke baffles, are permanently affixed to the building and intended to remain in place. They relate to the operation or maintenance of the building and are structural components.	1250	Building or Building Component	39 years
Energy Management Systems	Energy management systems control all energy-using systems in a building, automatically checking occupancy schedules, reading temperatures, and re-circuiting light levels, causing all heating, cooling, and lighting equipment to operate so as to minimize energy costs. Includes, for example, detection devices such as smoke, motion and infrared devices, photocells, foil and contact switches, pressure switches, proximity alarms, sensors, alarm transmitting controls, data gathering panels, demand controllers, thermostats, computer controls, outside air economizers, occupancy sensors, electronic ballasts, and all related wiring and conduit. May also provide for fire and burglary protection.	1250	Building or Building Component	39 years
Exit Signs	Signs posted along exit routes that indicate the direction of travel to the nearest exit. These signs typically read "EXIT" and may have distinctive colors, illumination, or arrows indicating the direction to the exit.	1250	Building or Building Component	39 years

Asset	Description	Property Type	Category	Recovery Period
Fire Protection & Alarm Systems	Includes sensing devices, computer controls, sprinkler heads, piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and wall mounted fire extinguishers necessary for the protection of the building.	1250	Building or Building Component	39 years
Fire Protection Equipment	Includes special fire detection or suppression systems directly associated with a piece of equipment. For example, a fire extinguisher designed and used for protection against a particular hazard created by the business activity.	1245	57.0 Distributive Trades and Services	5 years
Floor Coverings	Floor covering affixed with permanent adhesive, nailed, or screwed in place. Examples include ceramic or quarry tile, marble, paving brick, and other coverings cemented, mudded, or grouted to the floor; epoxy or sealers; and wood flooring.	1250	Building or Building Component	39 years
	Floor covering that is installed by means of strippable adhesives. For the retail industry, all vinyl composition tile (VCT), sheet vinyl, and carpeting will be treated as not permanently attached and not intended to be permanent. Also includes flooring that is frequently moved and reused to create a department theme or seasonal display.	1245	57.0 Distributive Trades and Services	5 years
Floors	Includes concrete slabs and other floor systems. Floors include special treatments applied to or otherwise a permanent part of the floor. For example "super flat" finish, sloped drainage basins, raised perimeter, serving line curb, or cooler, freezer and garbage room floors.	1250	Building or Building Component	39 years

2014 Workbook

Asset	Description	Property Type	Category	Recovery Period
Heating, Ventilating & Air Conditioning (HVAC)	Includes all components of a central heating, ventilating and air conditioning system not specifically identified elsewhere. HVAC systems that are installed not only to meet the temperature and humidity requirements of machinery, but are also installed for additional significant purposes, such as customer comfort and ventilation, are building components.	1250	Building or Building Component	39 years
	Only separate HVAC units that meet the sole justification test are included (i.e., machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs.) HVAC may meet the sole justification test even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. Includes refrigeration units, condensers, compressors, accumulators, coolers, pumps, connecting pipes, and wiring for the mechanical equipment for climate controlled rooms, walk-in freezers, coolers, humidors, and ripening rooms. Allocation of HVAC is not appropriate. See also Refrigerated Structures, Refrigeration Equipment, and Ripening Rooms.	1245	57.0 Distributive Trades and Services	5 years
Kiosks	A small retail outlet, often prefabricated, which acts like a fixed retail outlet yet is not permanent. Kiosks may be used to retail merchandise such as newspapers and magazines, film and digital images, and food and beverages. Kiosks are also present in shopping centers or malls where they function as temporary or portable retail outlets for a variety of merchandise.	1245	57.0 Distributive Trades and Services	5 years
Light Fixtures — Interior	Includes lighting such as recessed and lay-in lighting, night lighting, and exit lighting, as well as decorative lighting fixtures that provide substantially all the artificial illumination in the building or along building walkways. For emergency and exit lighting, see Fire Protection & Alarm Systems.	1250	Building or Building Component	39 years
	Decorative light fixtures are light fixtures, such as neon lights or track lighting, which are decorative in nature and not necessary for the operation of the building. In other words, if the decorative lighting were turned off, the other sources of lighting would provide sufficient light for operation of the building. If the decorative lighting is the <i>primary</i> source of lighting, then it is section 1250 property.	1245	57.0 Distributive Trades and Services	5 years

Asset	Description	Property Type	Category	Recovery Period
Light Fixtures — Exterior	Exterior lighting whether decorative or not is considered section 1250 property to the extent that the lighting relates to the maintenance or operation of the building. This category includes building mounted lighting to illuminate walkways, entrances, parking, etc.	1250	Building or Building Component	39 years
	Pole mounted or freestanding outdoor lighting system to illuminate sidewalks, parking, or recreation areas. See also Poles & Pylons .	^a	00.3 Land Improvements	15 years
	Plant grow lights or lighting that highlights only the landscaping or building exterior (but not parking areas or walkways) does not relate to the maintenance or operation of the building.	1245	57.0 Distributive Trades and Services	5 years
Loading Docks	Includes bumpers, permanently installed dock levelers, plates, seals, lights, canopies, and overhead doors used in the receiving and shipping of merchandise.	1250	Building or Building Component	39 years
	Includes items such as compactors, conveyors, hoists, and balers.	1245	57.0 Distributive Trades and Services	5 years
Millwork — Decorative	Decorative millwork is the decorative finish carpentry in a retail selling area. Examples include detailed crown moldings, lattice work placed over finished walls or ceilings, cabinets, cashwraps, counters, and toppers. The decorative millwork serves to enhance the overall décor of the retail store and is not related to the operation of the building. Cabinets and counters in a restroom are excluded from this category; see Restroom Accessories .	1245	57.0 Distributive Trades and Services	5 years
Millwork — General Building or Structural	General millwork is all building materials made of finished wood (e.g., doors and frames, window frames, sashes, porch work, mantels, panel work, stairways, and special woodworking). Includes pre-built wooden items brought to the site for installation and items constructed on site such as restroom cabinets, door jambs, moldings, trim, etc.	1250	Building or Building Component	39 years
Office Furnishings	Includes desk, chair, credenza, file cabinet, table, or other furniture such as workstations. Also includes telephone equipment, fax machines, and other communications equipment. Does not include communications equipment included in other asset classes in Rev. Proc. 87-56.	1245	00.11 Office Furniture, Fixtures, and Equipment	7 years

^a Asset class 00.3 Land Improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.

2014 Workbook

Asset	Description	Property Type	Category	Recovery Period
Parking Lots	Grade level surface parking area usually constructed of asphalt, brick, concrete, stone, or similar material. Category includes bumper blocks, curb cuts, curb work, striping, landscape islands, perimeter fences, and sidewalks.	1250	00.3 Land Improvements	15 years
Parking Structures	Any structure or edifice the purpose of which is to provide parking space. Includes, for example, garages, parking ramps, or other parking structures.	1250	Building or Building Component	39 years
Plumbing	All piping, drains, sprinkler mains, valves, sprinkler heads, water flow switches, restroom plumbing fixtures (e.g., toilets) and piping, kitchen hand sinks, electric water coolers, and all other components of a building plumbing system (water or gas) not specifically identified elsewhere.	1250	Building or Building Component	39 years
	Includes water, gas, or refrigerant hook-ups directly connected to appliances or equipment, eyewash stations, kitchen drainage, and kitchen hot water heater. For example, a hair salon in a retail outlet would require special hair washing sinks and water hook-up for the sinks.	1245	57.0 Distributive Trades and Services	5 years
Point of Sale (POS) Systems	A register or terminal based data collection system used to control and record all sales (cash, charge, COD, gift cards, layaway, etc.) at the point of sale. Includes cash registers, computerized sales systems and related peripheral equipment, satellite systems, scanners, and wands. See also Electrical for hook-ups.	1245	57.0 Distributive Trades and Services	5 years
Poles & Pylons	Light poles for parking areas and other poles poured in concrete footings or bolt-mounted for signage, flags, etc.	^a	00.3 Land Improvements	15 years
Refrigeration Equipment	Includes refrigeration units, condensers, compressors, accumulators, coolers, pumps, connecting pipes, and associated wiring. Refrigeration equipment is commonly found in climate controlled rooms, walk-in freezers, coolers, humidors, and ripening rooms.	1245	57.0 Distributive Trades and Services	5 years

^a Asset class 00.3 Land Improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56. See also **Signs and Light Fixtures — Exterior**.

Asset	Description	Property Type	Category	Recovery Period
Refrigerated Structures	Includes structural components such as walls, floors, ceilings, and insulation to construct a climate controlled structure, room or facility such as a cold storage warehouse, walk-in freezer, cooler, garbage room, or humidor. See also Refrigeration Equipment .	1250	Building or Building Component	39 years
	A portable structure installed inside the building, consisting of prefabricated panels mounted on a movable framework. Portable structures are designed to be able to be disassembled and moved. See also Refrigeration Equipment .	1245	57.0 Distributive Trades and Services	5 years
Restaurant — In Store	See Restaurant Industry Directive. For retail situations that include a restaurant or other food preparation property within a store, such as a deli or snack bar, the facts are similar to those considered in the industry directive on restaurants and that directive may be relied upon for asset classification.			
Restroom Accessories	Includes paper towel dispensers, electric hand dryers, towel racks or holders, cup dispensers, purse shelves, toilet paper holders, soap dispensers or holders, lotion dispensers, sanitary napkin dispensers and waste receptacles, coat hooks, handrails, grab bars, mirrors, shelves, vanity cabinets, counters, ashtrays, baby changing stations, and other items generally found in public restrooms that are built into or mounted on walls or partitions.	1250	Building or Building Component	39 years
Restroom Partitions	Includes shop made and standard manufacture toilet partitions, typically metal, but may be plastic or other materials.	1250	Building or Building Component	39 years
Retail Accessories	Accessories used to better display merchandise that are not held for sale. Includes assets such as audio/video display devices, artwork (if depreciable), holiday decorations, lamps, mirrors, pictures, plaques, potted plants, and decorative mobile props (such as coat of arms, sporting equipment, or memorabilia, etc., excluding non-depreciable art, antiques, or collectibles).	1245	57.0 Distributive Trades and Services	5 years
Retail Conveying Equipment	Includes assets such as belt or roller conveyors and pneumatic tube systems used to distribute retail merchandise.	1245	57.0 Distributive Trades and Services	5 years

2014 Workbook

Asset	Description	Property Type	Category	Recovery Period
Retail Equipment	Includes assets such as sewing machines, tackers, ironing equipment, pressing tables, steam presses, pinning machines, price mark guns, marking machines, work benches, power tools, check writers, endorsing machines, paper cutters, perforators, postage meters, money sorters, coin counting and dispensing equipment, and shopping carts.	1245	57.0 Distributive Trades and Services	5 years
Retail Fixtures	Includes assets such as back cases or islands, cabinets, cubes, deli cases, end caps, floor stands, garment racks, gondolas, grid systems, mannequins, refrigerator/freezer cases, shelving, sign holders or stands, show cases, wall display units, and other retail fixtures (such as dressing or fitting room partitions) needed in the business operation that are not a building component.	1245	57.0 Distributive Trades and Services	5 years
Retail Furniture	Includes furniture unique to retail stores and distinguishable from office furniture. For example, a high stool in a cosmetic department, a shoe department footstool, a hair salon barber chair, or a bench outside a dressing room. See also Office Furnishings .	1245	57.0 Distributive Trades and Services	5 years
Ripening Rooms	Special enclosed equipment boxes used to ripen produce by circulating special gases. The rooms are large boxes with special doors and large airplane-type propellers, which circulate the gases used to ripen the produce. The boxes are housed within a distribution center warehouse. These specialized facilities are considered to be part of the retail distribution equipment because they have a special retail purpose and cannot be used for any other purpose. The boxes are not a part of the building structure.	1245	57.0 Distributive Trades and Services	5 years
Roof	All elements of the roof including but not limited to joists, rafters, deck, shingles, vapor barrier, skylights, trusses, girders, and gutters. Determination of whether decorative elements of a roof (e.g. false dormers, mansard) constitute structural building components depends on their integration with the overall roof, not their load bearing capacity. If removal of the decorative element results in the direct exposure of building components to water, snow, wind, or moisture damage, or if the decorative element houses lighting fixtures, wiring, or other structural components, then the decorative elements are part of the overall roof system and are structural components of the building.	1250	Building or Building Component	39 years

Asset	Description	Property Type	Category	Recovery Period
Security Systems	Includes security equipment for the protection of the building (and its contents) from burglary or vandalism and protection of employees from assault. Examples include window and door locks; card key access systems; keyless entry systems; security cameras, recorders, monitors, and related equipment; perimeter and interior building motion detectors; security lighting; alarm systems; and security system wiring and conduit.	1250	Building or Building Component	39 years
	Electronic article surveillance systems including electronic gates, surveillance cameras, recorders, monitors, and related equipment, the primary purpose of which is to minimize merchandise shrinkage due to theft. Also includes teller-style pass-through windows, security booths, and bulletproof enclosures generally located in the cash office and customer service areas.	1245	57.0 Distributive Trades and Services	5 years
Signs	Exit signs, restroom identifiers, room numbers, and other signs relating to the operation or maintenance of a building.	1250	Building or Building Component	39 years
	Interior and exterior signs used for display or theme identity. For example, interior signs to identify departments or exterior signs to display trade names or trade symbols. For pylon signs, includes only sign face. See also Poles & Pylons.	1245	57.0 Distributive Trades and Services	5 years
Site Preparation, Grading & Excavation	In general, land preparation costs include the one time cost of clearing and grubbing, site stripping, fill or excavation, and grading to allow development of land. Clearing and grubbing is the removal of debris, brush, trees, etc. from the site. Stripping is the removal of the topsoil to provide a stable surface for site and building improvements. The grading of land involves moving soil for the purpose of producing a more level surface to allow development of the land.		Land	
	Clearing, grading, excavating, and removal costs directly associated with the construction of buildings and building components are part of the cost of construction of the building and depreciated over the life of the building.	1250	Building or Building Component	39 years
	Clearing, grading, excavating, and removal costs directly associated with the construction of sidewalks, parking areas, roadways, and other depreciable land improvements are part of the cost of construction of the improvements and depreciated over the life of the associated asset.	1250	00.3 Land Improvements	15 years

2014 Workbook

Asset	Description	Property Type	Category	Recovery Period
Site Utilities	Site utilities are the systems that are used to distribute utility services from the property line to the retail building. Includes water, sanitary sewer, gas, and electrical services.	1250	Building or Building Component	39 years
Site Work	Site work includes curbing, paving, general site improvements, fencing, landscaping, roads, sewers, sidewalks, site drainage, and all other site improvements not directly related to the building. For sanitary sewers, see Site Utilities .	1250	00.3 Land Improvements	15 years
Sound Systems	Equipment and apparatus, including wiring, used to provide amplified sound or music. For example, public address by way of paging a customer or background music. Excludes applications linked to fire protection and alarm systems.	1245	57.0 Distributive Trades and Services	5 years
Trash Enclosures	Enclosures for waste receptacles that are attached to the building. Typically constructed of the same materials as the building shell with either interior or exterior access. These trash enclosures are an integral part of the building shell and cannot be moved without damage to the underlying building.	1250	Building or Building Component	39 years
	Freestanding enclosures for waste receptacles, typically constructed on a concrete pad with its posts set in the concrete. Serves both safety and decorative functions.	1250	00.3 Land Improvements	15 years
Wall Coverings	Includes interior and exterior paint; ceramic or quarry tile, marble, stone, brick, and other finishes affixed with mortar, cement, or grout; paneling, wainscoting, and other wood finishes affixed with nails, screws, or permanent adhesives; and sanitary kitchen wall panels such as fiberglass, stainless steel, and plastic wall panels.	1250	Building or Building Component	39 years
	Strippable wallpaper that causes no damage to the underlying wall or wall surface.	1245	57.0 Distributive Trades and Services	5 years
Walls — Exterior	Includes all exterior walls and building support regardless of construction materials. Exterior walls may include columns, posts, beams, girders, curtain walls, tilt-up panels, studs, framing, sheetrock, insulation, windows, doors, exterior facade, brick, masonry, etc. Also includes drive-through bay, windows, and doors.	1250	Building or Building Component	39 years

Asset	Description	Property Type	Category	Recovery Period
Walls — Interior Partitions	Includes all load bearing interior partitions regardless of construction. Also includes non-load bearing partitions regardless of height (typically constructed of studs and sheetrock or other materials) that divide or create rooms or provide traffic control. Includes rough carpentry and plaster, drywall or gypsum board, and other finishes.	1250	Building or Building Component	39 years
	Interior walls for merchandise display where the partition can be 1) readily removed and remain in substantially the same condition after removal as before, or 2) moved and reused, stored, or sold in their entirety.	1245	57.0 Distributive Trades and Services	5 years
Windows	Exterior windows, including store front windows, drive-through service and carousel windows, and vestibule.	1250	Building or Building Component	39 years
Window Treatments	Window treatments such as drapes, curtains, louver, blinds, post-construction tinting, and interior decorative theme décor which are readily removable.	1245	57.0 Distributive Trades and Services	5 years

APPENDIX B — AUTOMATIC CHANGES OF ACCOUNTING METHOD (FORM 3115 MUST BE FILED)¹²⁷

CHANGES UNDER THE FINAL TANGIBLE PROPERTY REGULATIONS

Description of Change	Designated Change Number (DCN)	Citation
A change to deducting amounts paid or incurred for repair and maintenance or a change to capitalizing amounts paid or incurred for improvements to tangible property and, if depreciable, to depreciating such property under section 167 or section 168. Includes a change, if any, in the method of identifying the unit of property, or in the case of a building, identifying the building structure or building systems for the purpose of making this change.	184	§§1.162-4, 1.263(a)-3
Change to the regulatory accounting method.	185	§1.263(a)-3(m)
Change to deducting non-incidental materials and supplies when used or consumed.	186	§§1.162-3(a)(1), (c)(1)
Change to deducting incidental materials and supplies when paid or incurred.	187	§§1.162-3(a)(2), (c)(1)
Change to deducting non-incidental rotatable and temporary spare parts when disposed of.	188	§1.162-3(a)(3), (c)(2)
Change to the optional method for rotatable and temporary spare parts.	189	§1.162-3(e)
Change by a dealer in property to deduct commissions and other transaction costs that facilitate the sale of property.	190	§1.263(a)-1(e)(2)
Change by a non-dealer in property to capitalizing commissions and other costs that facilitate the sale of property.	191	§1.263(a)-1(e)(1)
Change to capitalizing acquisition or production costs and, if depreciable, to depreciating such property under section 167 or section 168.	192	§1.263(a)-2
Change to deducting certain costs for investigating or pursuing the acquisition of real property (whether and which).	193	§1.263(a)-2(f)(2)(iii)
Change for banks and other lenders acquiring real estate via foreclosure to allow expensing of the acquisition and holding period costs of the property acquired.	195	§1.263A-3(a)(1))

¹²⁷ Rev. Proc. 2014-16, 2014-9 IRB 606.