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IRS Final Regulations Governing Repairs and Capitalization - September 13, 2013



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On September 13, 2013, the IRS released the final "repair" regulations (T.D.9636) governing when taxpayers must capitalize and when they can deduct their expenses for acquiring, maintaining, repairing and replacing tangible property. The final regulations must be followed by all taxpayers starting in tax years beginning on or after **January 1, 2014**, and may be followed retroactively back to the start of 2012 at a taxpayer's discretion. A taxpayer may choose to apply the final regulations to tax years beginning on or after **January 1, 2012**.

Code Sec. 263 requires the capitalization of amounts paid to acquire, produce, or improve tangible property. Code Sec. 162 allows the deduction of all ordinary and necessary business expenses, including the costs of certain supplies, repairs, and maintenance. In the final regulations by the IRS, a general framework for distinguishing capital expenditures from deductible supply, repair and maintenance costs is provided.

The Final Regulations affect the following main areas and are outlined as below:

1. Non-Incidental Materials & Supplies

The cost of non-incidental materials and supplies are generally deducted in the tax year first used or consumed. The final regulations state that rotatable parts, temporary spare parts, and stand-by emergency parts are materials and supplies that are to be deducted in the year used or consumed unless the taxpayer elects to capitalize the depreciation the spare parts over the applicable recovery period. If the taxpayer chooses to capitalize and depreciate the spare parts, then the method must be used for all of the taxpayer's spare parts in the same trade or business.

2. Routine Repairs & Maintenance

Under a routine maintenance safe harbor, an amount paid is deductible if it is for recurring activities that a taxpayer expects to perform to keep a unit of property in its ordinarily efficient operating condition. The activities are routine only if, at the time the unit of property is placed in service, the taxpayer reasonably expects to

perform the activities more than once during the class life of the unit of property.

The final regulations allow expensing for routine maintenance activities on a building and its structural components, provided the taxpayer reasonably expects to perform such maintenance **more than once over a 10-year period**.

The final regulations allow taxpayers to make an annual election to opt out of expensing repair and maintenance costs if the taxpayer treats the costs as capital expenditures on its books and records. A taxpayer must elect to capitalize these expenses on its return and depreciate them. The election applies to all amounts paid for repair and maintenance to tangible property that the taxpayer treats as capital expenditures on its books and records for the tax year. The election is made by attaching a statement to the taxpayer's timely filed original tax return (including extensions) for the tax year in which the repair and maintenance expenditures are paid.

3. Capital Expenditures

A taxpayer is generally required to capitalize amounts paid to acquire or produce a unit of real or personal property. The IRS provided a de minimis exception in the final regulations, that allow the taxpayer with an applicable financial statement may deduct up to \$5,000 of the cost of an item of property per invoice (or per item as substantiated by an invoice). The required written accounting procedures in effect as of the beginning of the tax year may specify a per item amount of less than \$5,000. The final regulations allow taxpayers without an applicable financial statement to elect the de minimis safe harbor and expense up to \$500 per invoice/item.

To take advantage of the \$5,000 de minimis rule, taxpayers must have written book policies in place at the start of the tax year that specify a per-item dollar amount (up to \$5,000) that will be expensed for financial accounting purposes. **Calendar-year taxpayers, therefore, should work on having a policy in place by year-end 2013 to qualify for 2014.**

The final regulations also expand the safe harbor to include amounts paid for property with an economic useful life of 12 months or less if the taxpayer's accounting procedures in place at the beginning of the tax year provide for the current deduction of such amounts. The cost of each item of short-lived property that is deductible under this de minimis rule may not exceed \$5,000 (\$500 for taxpayers without an applicable financial statement).

A taxpayer must include all additional costs, such as delivery fees, installation services, and similar costs that are included on the same invoice as the invoice for the cost of the property. It is advisable for the taxpayer, wherever possible, to arrange in advance for separate invoices for the property item and additional costs as it could increase the cost over the \$5,000/\$500 threshold, and thereby cannot be expensed. If these additional costs are not included on the same

invoice as the property the taxpayer may, but is not required to, include the additional costs in the item of property.

4. Improvements

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

- A **betterment** to the unit of property;
- A **restoration** of the unit of property; or
- An **Adaptation** of the unit of property to a new or different use.

The final regulations include an annual safe harbor election for buildings owned or leased by a small taxpayer with an unadjusted basis (i.e., generally cost) no greater than \$1 million. The small taxpayer is not required to capitalize improvements if the total amount paid for repairs, maintenance, improvements and similar activities during the year that are performed on the building does not exceed the lesser of \$10,000 or two percent of the unadjusted basis of the building. Amounts deducted under the de minimis rule or the new safe harbor elections for routine maintenance are counted toward the \$10,000 limit. No amount is deductible under the safe harbor for buildings if this limit (or the \$1 million adjusted basis limit) is exceeded. The safe harbor is applied separately to each building owned or leased by the taxpayer. The taxpayer must have average **annual gross receipts of \$10 million** or less during the three preceding tax years to qualify as a 'small taxpayer'. Gross receipts are specially defined and include income from sales (unreduced by cost of goods), services, and investments.

5. Betterments

Betterments are required to be capitalized and depreciated over the useful life of the improvement. In the Final regulations, the IRS has clarified the betterment rules, which are defined as expenditures:

- **That improve a material condition** or defect that existed prior to the acquisition of the property or arose during the production of the property;
- **That is incurred for a material addition**, including a physical enlargement, expansion, extension, or addition of a major component to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property;
- That is reasonably expected to **materially increase the productivity, efficiency, strength, quality, or output** of the unit of property.

Property Dispositions - Re-proposed MACRS Regulations

The IRS did not finalize or remove the temporary regulations under Code Sec. 168 on general asset accounts and the disposition of depreciable property. Instead, the IRS issued new proposed regulations (REG-110732-13). The proposed regulations will affect all taxpayers that dispose of MACRS property. Because the changes are substantial, the IRS decided it needed to give taxpayers another opportunity to comment on them. The IRS reported that it aims to finalize the proposed regulations in time to have the same January 1, 2014 effective date as the final repair regulations.

Source: IRS, CCH.

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