MS CONSULTANTS, LLC
Cost Segregation Studies & More

IRS Audit Technique Guide:

Repair vs. Capitalization

All information provided below comes from the IRS's Cost Segregation Audit Techniques Guide, which can be found at the following address:

http://www.irs.gov/businesses/article/0,,id=231440,00.html#13

PLEASE NOTE: Audit Technique Guides are not to be taken as law or as the authoritative definition of a given topic. However, as their names suggest, they are guidance for IRS examiners in the case of an audit or other scrutiny. As such, they can provide great insight for tax professionals as to how best to go about conducting tax studies and preparing reports.

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Capitalization v Repairs Audit Technique Guide

LB&I-4-0910-023

November 2010

This document is not an official pronouncement of the law or the position of the Service and cannot be used, or cited or relied upon as such.

This Audit Techniques Guide (ATG) should be used as a tool, to assist examiners determine whether an expenditure should be capitalized or deducted. Whether an expenditure qualifies as a currently deductible repair, or is required to be capitalized is a factual determination. The burden of proof rests with the taxpayer, and sufficient contemporaneous records are required.

To re-characterize previously capitalized expenditures as currently deductible repairs, taxpayers and their representatives will make a Change in Accounting Method (CAM) request. These CAM requests may go back many years, with taxpayers reviewing data from the 1990s and earlier to provide numbers for these changes. To justify a change in method, taxpayers will need to explain why they are changing their treatment of these expenditures.

Examiners should consider the following steps when reviewing/examining this issue. Potential IDR questions have been developed to assist examiners in identifying the appropriate information to request from the taxpayer.

1. Identify Issue

1. Review Form(s) 3115, advanced consent agreement(s) or automatic consent requests, and all correspondence between the taxpayer and the National Office to identify the legal authority the taxpayer is using to support their change in accounting method. See Appendix A for more information.
2. Determine specifically what accounting method changes were filed.
    1. Capitalization to Repair. See Appendkix B.
    2. Unit of Property identification (UOP). See Appendix C.
    3. Dispositions of property. See Appendix D.
3. Read Annual Reports and Forms 10-K to identify new facilities, expansions of old facilities, or other changes impacting fixed assets.
4. Review Industry Director Directive #1 and Industry Director Directive #2 as well as additional information found externally on irs.gov.

2. Assess Audit Risk

This is a list of steps that examiners can apply to their facts and circumstances to assess the audit risk:

1. Determine the amount of the § 481(a) adjustment and compare it to the § 481(a) adjustment filed on Form 3115. Inquire as to differences and ensure the numbers have been finalized.
2. Determine if a Capitalization to Repair Study was conducted and which entities are included in the Study.
3. Read Engagement Letter to determine the extent of the Study.
4. Read the Study, presentation materials, and correspondence to evaluate the depth, accuracy, and methodology of the Study.
    1. Determine the population of assets included in the Study.
    2. Identify UOP as defined by the Study.

    3. Identify the method used to reclassify costs.
        1. Was a database word search done to analyze costs?
        2. Were project folders reviewed?
        3. Was some other method employed?
    4. Determine if a sampling method was used to determine the § 481(a) adjustment.
    5. Review the Form 3115 to identify the legal authority the taxpayer is using to support their change in accounting method.
5. Analyze Schedule M adjustments for depreciation reporting differences.
6. Review taxpayer's written policies regarding asset capitalizations and depreciation. Consider any capitalization threshold statements.
7. Identify any unique facts and circumstances.

3. Determine Audit Scope and Consider Exam Timeline

1. Identify types of assets reclassified. Consider Industry specific issues.
    1. All Industries – Buildings and their components.
    2. All Industries – Land Improvements.
    3. Retail – Store Remodel Projects.
    4. Utilities and Telecommunications – Power Generation Assets and Network Assets such as poles, cables, and wires.
    5. Any other Industry specific assets categories.
2. Consider any prior Closing Agreements impacting Fixed Assets.
3. Consider prior Cost Segregation or similar studies conducted for the assets included in the Study.
4. Inquire as to UOP determinations both past and present.
5. Determine the taxpayer's routine maintenance policy with respect to its properties.
    1. Establish which department approves maintenance projects.
    2. Examine the criteria for performing maintenance. This criteria may enumerate the benefits and value-added for repairs.
6. Request all written policies regarding Fixed Assets.
7. Determine the taxpayer's asset retirement policy and consider whether that treatment has changed as a result of the Study.
8. Consider the treatment of prior dispositions, including the disposal of a component or structural component of a larger UOP which is now considered a repair.
9. Establish audit criteria (e.g., project, dollar, other threshold).
10. Consider the use of specialists early in exam.
    1. Engineering referral or consult to consider issues involving cost segregation, industry specific property, land improvement properties, plant process equipment and other assets.
    2. Computer Audit Specialists to assist with understanding the taxpayer's sampling methodology and evaluate the need for a statistical sample of the taxpayer's study to minimize audit resources. See Appendix F.

4. Determine Availability of Information and Review

1. Request all electronic data files used to complete the Study.
2. Identify documentation reviewed by consultants/taxpayer to determine whether a particular cost is capital or ordinary.
    1. Blue prints for original building construction and improvements.
    2. American Institute of Architects (AIA) Form G-702.
    3. Building and occupancy permits.
    4. Contract documents.
    5. Construction project billings.
    6. Purchase orders and original invoices.
    7. Project Folders, Project Files or Authorization for Expenditures (AFEs).
    8. Study binders and all related materials considered to re-characterize assets included in the § 481(a) and current year adjustments.

5. Conduct Interviews

1. Obtain a list of company officials interviewed by the consultant as part of the Study.
2. Interview the consultants and company officials familiar with the Study.
3. Identify any common nomenclature used as part of the Study.
4. Identify the use of a standard numbering system, if any.

6. Inspect Property

1. Prepare a list of questionable costs prior to inspecting property.
2. Conduct site visits to understand nature of the costs.
3. Photograph questionable items.

7. Determine Basis of Re-Characterized Assets and Reconcile Depreciation Records

1. Determine if costs were extracted from the general ledger or fixed asset records.
2. Review and reconcile the Study cost to the detailed depreciation schedules.
3. Consider the impact of related Code and Regs and published guidance to asset basis including the following:
    1. IRC §118 and §362 Basis adjustments.
    2. IRC §165 Insurance proceeds received for costs previously capitalized.
    3. Treas. Reg. §1.167(a)-8 Retirements.
    4. Treas. Reg. §1.167(a)-11 Repair Allowance Deductions.
    5. IRC §168(e) 15 year for Retail. vi. IRC §168(k) Bonus Depreciation.
    6. IRC §174 Research & Development
    7. IRC §179 Additional 1st year Depreciation.
    8. IRC § 263A Capitalization Indirect Costs on Self Constructed Assets.
    9. IRC § 263A Mixed Service Costs.
    10. IRC § 263A(f) Interest Capitalization.
    11. Rev. Rul. 2000-7 Removal Costs.

8. Review Costs Reclassified as Repairs

1. Analyze detailed records to determine the reason the work was undertaken. Consider carefully all underlying documentation including Management Reports, Engineering Assessments and Invoice Language.
2. Determine extent to which costs were treated as UOP separate from the primary UOP.
3. Determine asset's age, acquisition date, and any prior completed work that is related to that asset.
4. Determine the purpose of project. Consider what was done, why it was done and the dates the project began and ended. Consider how soon the work will have to be repeated. Consider Long-Term projects and consider whether expenditures:
    1. Result in new assets.
    2. Improve the property, putting it in a better operating condition.
    3. Add new components or material sub-components.
    4. Add upgrades or modifications.
    5. Enhance the value of the property in the nature of a betterment.
    6. Extend the useful life of the property.

7. Improve the efficiency, quality, strength, or capacity of the property. viii. Adapt the property to a new use.

9. Apply Current Law to Facts & Circumstances

1. Apply § 263(a) and Treas. Reg. §1.162-4.
    1. Capitalize costs that materially add to UOP's value.
    2. Capitalize costs that appreciably prolong UOP's economic life.
    3. Capitalize costs that adapt UOP to a new or different use.
2. Apply relevant court cases. See Appendix B or Appendix C.
    1. Capitalize indirect costs that are part of an overall plan of rehabilitation (judicial doctrine) or § 263A.
3. Apply Rev. Rul. 2001-4 to applicable fact patterns.

10. Consider Tax Treatment of Related Issues

1. In addition to changes made through basis adjustments, also consider the impact to related computations that may not be reflected on the detailed depreciation work papers. See Appendix E.
    1. § 199 Domestic Production Deduction QPAI.
    2. § 199 Domestic Production Deduction § 481(a) impact.
    3. § 263A(f) Interest Capitalization.
    4. § 280B Demolition Costs.
    5. § 1019 Leasehold Improvements – rent concessions.
    6. § 1031 Property Involved in Like Kind Exchanges.
    7. Impact to the AMT or ACE computation.

11. Summarize Audit Findings and Discuss with Taxpayer

1. Prepare Forms 5701 and 886-A.
2. Consult with appropriate Industry or Issue Technical Advisor.
3. Issue and discuss proposed adjustment with taxpayer.

12. Potential IDR Items

Below are items examiners should consider incorporating into an IDR, or IDRs, depending on the facts and circumstances of each case:

1. Executed copy of the engagement letter for the repair study.
2. Copies of all presentation materials prepared by or on behalf of the company.
3. Copies of written communications including technical memos, process memos and statistical sampling plans to support the Change in Method of accounting for tangible property.
4. Copies of legal guidance precipitating the change in treatment of costs previously capitalized.
5. Copies of any prior agreements with the IRS that impact with the assets included in this study or the method of accounting used. These agreements would include closing agreements with either Examination Division or Appeals.
6. If the company is obligated to maintain their books as required by a regulatory agency, identify and discuss the impact.
7. Was any cost segregation or similar studies previously performed? If yes, provide each study and, if filed, Form 3115 and the related work papers, reclassifications, computations, etc.
8. Does the company use a materiality threshold for capitalization? If so, please provide written support for all current and past policies.

With respect to the Form 3115 Consent Agreement(s):

9. Copy of each Advanced Consent Agreement filed and all related correspondence between the company and the National Office.
10. Copy of each Automatic Consent Agreement filed as well as all supporting documents prepared in response to Revenue Procedure 2009-39.
11. Copy of the § 481(a) computation with respect to the Change in Accounting Method.
12. If the amount of the § 481(a) adjustment per return differs from the § 481(a) adjustment contained on Form 3115, please provide an explanation for the difference.

With respect to the Repair Study:

13. Electronic data files of the complete repair study including all schedules, spreadsheets, check sheets and attachments. (excel format if possible)
14. Access to all engineering studies, construction drawings, specifications, or similar documentation for assets included in the repair study.
15. List of all property locations visited in preparing the repair study.
16. List containing names and titles of all company personnel interviewed for the repair study and copies of the interview notes resulting from these interviews.
17. Which entities are included in this study?
18. How did you determine the population to be considered in this study?
19. What are the primary projects covered by this study? (1245, 1250 property, categories of properties)
20. What methodology was used in preparing the repair study:
    1. Sampling - Judgment, Modeling, Statistical, other? Discuss.
    2. Actual costs or estimated costs? Discuss.
    3. Dollar thresholds? Discuss.
21. Was the study based on:
    1. Contemporaneous records?
    2. Reconstructed records?
    3. Estimates without supporting documentation?
22. What is the company's asset retirement policy with respect to capitalized property that is replaced (e.g., abandonment loss, continuation of depreciation, other)? Did the treatment change as a result of the repair study?
23. What is the company's routine maintenance policy with respect to its properties? What department is responsible for overseeing and performing routine maintenance? Discuss.
24. Does the company have a minimum threshold for capitalizing costs for book and for tax? Provide any written policy statements to this effect. Discuss.
25. How were any asset dispositions treated for tax? For books? (both 1245 and 1250 property)

With respect to the Unit of Property:

26. Project files for each project included in the repair study. These files should contain explanations of the condition of the property prior to the project, what work was done, why it was done, when the project began and ended.
27. All company planning files and related contracts addressing the construction of additions, reconstruction of properties, reconfiguring of property (§§ 1245 and 1250), adding or upgrading structural components.
28. Describe the UOP determinations made for the repair study. Provide supporting tax law for each.
29. How have the UOP definitions changed for your company currently as opposed to the definitions used in prior years?

With respect to Computations:

30. Copies of the depreciation and/or fixed asset schedules, for book and for tax, pre and post change in accounting method.
31. Computations for § 263A costs inclusive of § 263A(f) interest capitalization costs related to self-constructed assets. Were there any changes made to the computations as a result of the repair study?
32. Computations made as a result of this Change in Accounting Method. Be sure to include computational changes to the Domestic Production Deduction § 199; Research & Experimental Expenses § 174; Basis

Adjustments § 1016; Contributions to Capital §§ 118 and 362.

33. Have any insurance proceeds been received with respect to costs previously capitalized? If yes, how were the proceeds treated for book and for tax?
34. Were any landlord incentives received to build out leased spaces? If yes, how were these incentives treated for book and for tax?
35. Were any monetary incentives (including, but not limited to, tax incentives, vendor/supplier incentives, construction allowances) received from third parties or state or local governments with respect to any properties? If yes, how were these incentives treated for book and for tax?
36. Has this Change in Accounting Method impacted the AMT or ACE computation?

With respect to Remodels:

37. Copy of the company's policy with respect to remodels.
38. List of names and titles of company employees who oversee remodeling projects.
39. Copies of all approved project folders for the assets impacted by the repair study.
40. What is the company's capital budget process for initiating and approving remodels?
41. How often are stores or business premises remodeled? Discuss.
42. Describe and discuss the type of work performed in a store remodel:
    1. Major remodel;
    2. Medium remodel;
    3. Small remodels;
    4. Other remodel.
43. How are remodeling costs treated pre and post repair Study? Discuss.
44. Are remodeling costs tracked on a project basis? Discuss.
45. How are remodeling costs treated for GAAP?

With respect to any Additional Documents:

46. Should any documents exist which relate in any way to the issue identified in this IDR and which the taxpayer asserts are privileged, please provide a privilege log for these documents. The privilege log should include: the date of the document; identification of the author, sender, and recipient of the document; subject matter of the document; specific privilege asserted with respect to the document; and a list of all people or entities that have been provided the document. This request applies to all privileged information with respect to this issue irrespective of whether the privileged information was specifically requested in this IDR.

APPENDIX A: CHANGE IN ACCOUNTING METHOD

Prior to August 27, 2009, taxpayers filing for a CAM to change from capital/depreciable to current expense treatment for previously capitalized "repair costs" were required to file Form 3115 using Revenue Procedure 97-27. Many taxpayers received permission to change their method of accounting under these advance consent request requirements. The consent letters were however, subject to significant caveats, effectively placing responsibility on the field to determine whether the new method is permissible by examining the facts.

As of August 27, 2009, taxpayers filing Form 3115 for this change for a year of change ending on or after December 31, 2008, generally must now file using the Automatic Consent provisions contained in Revenue Procedure 2008-52, as modified by Revenue Procedure 2009-39. Section 2.08 of Rev. Proc. 2009-39 added new Appendix section 3.06 to Rev. Proc. 2008-52, which applies to "Repair and Maintenance Costs." Appendix section 3.06 provides automatic consent for a taxpayer that changes its method of accounting from capitalizing under § 263(a) to deducting repair and maintenance costs as ordinary and necessary business expenses under § 162 and Treas. Reg. § 1.162-4 in compliance with current law. This change also applies to a taxpayer that wants to change the unit of property (UOP) it uses to determine the deductibility of repair and maintenance costs to a UOP that is permissible under applicable legal authority.

Revenue Procedure	**Year of Change**	**Remarks**
97-27 as modified by RP2002-19	Tax years beginning before August 27, 2009, if Form 3115 was filed prior to 8/27/2009, and either: 1) Consent had been granted before 8/27/2009, or 2) Consent granted on or after 8/27/2009, and taxpayer did not use transition rules to convert request to an automatic consent request.	Advance consent; generally used prior to August 27, 2009, when automatic change was not available; **one-year** reporting of a negative § 481(a) & four year reporting of a positive § 481(a) adjustment.
2008-52 as modified by RP 2009-39	Tax years ending on or after 12/31/2008, if: 1) Form 3115 was filed on or after 8/27/2009, or 2) Advance consent request was still pending on 8/27/2009, and taxpayer used transition rules to convert request to an automatic consent request.	Automatic consent; generally used on or after August 27, 2009; **one-year** reporting of a negative § 481(a) adjustment & four-year reporting of a positive § 481(a) adjustment. :

Rev. Proc. 2008-52 Appendix section 3.06 contains special requirements that a taxpayer must meet to obtain automatic consent for capital to repair changes and associated UOP changes. Among these is the requirement that the taxpayer make the following affirmative representations regarding the costs to which the change applies

1. The costs are incurred to keep the taxpayer's property in ordinarily efficient operating condition;
2. The expenditures do not materially increase the value of nor substantially prolong the useful life of any UOP compared to the value or useful life of the property before the general wear or tear or particular event that led to the repairs or maintenance;
3. The costs do not adapt any UOP to a new or different use;
4. The expenditures do not include costs to replace any UOP or any major components or substantial structural parts of any UOP;
5. The costs are not incurred as part of a plan of rehabilitation, modernization, or improvement to any UOP; and

6. The costs do not result from any prior owner's use of any UOP.

Neither the advance consents nor the automatic consents are to be construed as a determination by the Commissioner that the taxpayer is using the appropriate UOP in determining the deductibility of repair and maintenance costs. This determination is to be made on examination.

Besides determining whether the taxpayer's required affirmative representations are correct and the UOPs comply with the law, it is specifically the responsibility of the examiner to verify the accuracy of the amount of the § 481(a) adjustment upon examination. The examiner should evaluate the need to review the study that formed the basis for increased "expense" treatment and any correlative depreciation adjustments resulting from the change in accounting method. Note that a new Schedule M adjustment without a Form 3115 may be an indication of a change in accounting method made without first obtaining the required consent of the Commissioner.

Cost Segregation and Asset Reclassification

Many taxpayers previously changed their accounting methods for depreciation pursuant to a study that separated components of an asset into separate tangible assets and/or reclassified separate assets into an asset class that qualified for a shorter recovery period. Some taxpayers are filing method change requests for this change in conjunction with the "Repair and Maintenance Cost" method change that is the subject of this discussion. The examiner should review the assets identified in any cost segregation or asset reclassification study and determine whether the taxpayer is being consistent in their classification of § 1245 property (generally, personal property) and § 1250 property (generally, real property) for purposes of both (1) asset identification/classification; and (2) determining whether an expenditure relating to that asset should be capitalized or treated as a repair expense deduction. If an item is identified as a tangible asset and treated as § 1245 property for purposes of asset classification and/or depreciation, it cannot be treated as a structural component of a building and a replacement of a component of § 1250 property in order to obtain repair expense treatment.

Note that an examiner may not deny a "Repair and Maintenance Cost" change merely because the taxpayer requested consent for a depreciation change relating to a cost segregation study within the 5 tax years ending with the year of change. The "5-year rule" is **only** relevant for determining whether a taxpayer is eligible to use the automatic consent procedure. As clarified in Rev. Proc. 2008-52, when a taxpayer is prohibited from using the automatic consent procedure because of the "5-year rule", they must use the advance consent procedure to request consent to change their accounting method for the same item. Consequently, the examiner must develop the facts relating to the specific items included in the "Repair and Maintenance Cost" change and determine whether the same item was included in the prior depreciation change request. If a taxpayer relied on a cost segregation study to identify a specific item as a separate asset (UOP), or applied for consent to change a method of accounting for a specific item regardless of whether they implemented that change during any of the 5 taxable years ending with the year of change they are prohibited from using the automatic consent procedure to change their accounting method for the same item. For example, a taxpayer may not use the automatic consent procedure to "reverse" their treatment of that item as a separate asset pursuant to a change in the defined UOP in order to treat their expenditure for that same item as a deductible repair expense. Because the taxpayer is not within the scope of the automatic consent procedure (pursuant to the "5-year rule") with respect to the identification of that item as a component of an asset as opposed to a separate asset, the examiner has the authority to "carve out" from the "Repair and Maintenance Cost" § 481(a) adjustment those items that were also included in the prior depreciation change request.

Unit of Property and Dispositions

Most taxpayers are changing the definition of a UOP concurrently with the change in determining capital versus repair expense treatment, often using a functional interdependence analysis, resulting in a larger UOP made up of many components that were previously treated as separate assets. The UOP for depreciation and retirement purposes may not be the same as the UOP for repair/capitalization purposes (see CCA 201013045). Note that a "retirement" is one, but not the only, form of disposition.

The examiner should determine whether the taxpayer is using the same definition for a UOP for purposes of both (1) asset depreciation/disposition and (2) determination of whether an expenditure should be capitalized or treated as a repair expense deduction. If the taxpayer is using different definitions for (1) and (2), then the examiner should verify whether the taxpayer's new method of determining repairs expenses and claimed 481(a) adjustment are consistent with its claimed dispositions in previous years. Previously, using the smaller separate asset as the UOP, the taxpayer treated the costs of replacing that asset as a capital expenditure and treated the adjusted basis of the original asset as a disposition. Having now changed the definition of the UOP to a larger asset, the taxpayer would like to treat the replacement of what is now a “component” as a qualifying repair expense. However, if the original smaller separate asset has been treated as a disposition, the taxpayer has a dilemma, because there is no “component” to be repaired or replaced and therefore any expenditure to install a new “component” is a betterment that must be capitalized.

For example, a taxpayer placed a building and structural components in service in year 1, and replaced the roof and windows of the building in year 5. In year 5, the taxpayer treated the original roof and windows as a disposition/retirement and deducted the adjusted basis of these assets, while capitalizing the cost of the new roof and windows. Now, having identified the entire building as the UOP, the taxpayer has filed a Form 3115 to treat the adjusted basis of the costs that were capitalized in year 5 as qualified repair and maintenance costs. However, if the original roof and windows have been treated as a disposition, there is neither a roof nor windows available for “repair.” Unless and until the disposition/retirement of the original asset is reversed and the adjusted basis (net of allowable depreciation from year 5 to the present) is restored to income, there can be no consideration of whether the year 5 costs for the new roof and window are eligible for repair expense treatment. (Refer to Appendix D of this guide for additional information on dispositions).

New Appendix sections 6.24 and 6.25 of Rev. Proc. 2008-52 are available for taxpayers who want to make changes with respect to the UOP used in determining when the taxpayer has disposed of structural components of a building and depreciable tangible assets (other than structural components of a building), respectively. Examiners must be alert for situations where a taxpayer changes their defined UOP in a “Repair and Maintenance Cost” change and ignores the impact of that definition with respect to retirements or other dispositions of assets affected by that change.

These correlative changes **should** be addressed in an automatic consent request filed under Appendix sections 6.24 or 6.25, as applicable. If a taxpayer consistently incorporates the impact of a change in the defined UOP for a disposition into the same Form 3115 filed for “Repair and Maintenance Costs” (filed in compliance with all applicable provisions of Appendix section 3.06 of the automatic consent procedure, including required representations), the examiner may use their discretion in applying section 9.02 of Rev. Proc. 2008-52. However, if the taxpayer simply ignores the impact of their new definition of a UOP with respect to retirements or other dispositions of assets, an issue should be raised by Exam.

Questions regarding Change of Accounting Method filings should be directed to the Change of Accounting Method Technical Advisors.

APPENDIX B: CAPITALIZATION VS. REPAIRS

History

Since the Reconstruction Era Income Tax Act of 1870, there has been a deduction limitation that prohibits a taxpayer from deducting amounts paid for new buildings, permanent improvements, or betterments made to increase the value of property. While this concept has been recognized as part of tax law almost from its inception, exactly what must be capitalized and what may be currently deducted has been at issue ever since.

In general, the costs incurred to create or enhance an asset must be capitalized under § 263(a) **Commissioner v. Lincoln Savings & Loan Association**, 403 U.S. 345 (1971). However, the mere presence of an ensuing benefit that extends beyond the current year is not controlling and many expenses have prospective effect beyond the taxable year. Therefore, a future benefit alone does not warrant capitalization.

The Supreme Court has recognized that the decisive distinctions between current expenses and capital expenditures are those of degree and not of kind. **Welch v. Helvering**, 290 U.S. 111 (1933); **INDOPCO, Inc. v. Commissioner**, 503 U.S. 79 (1992). Careful examination of the particular facts and circumstances in each case is required to determine whether a current deduction or capitalization is the appropriate tax treatment, **Deputy v. Du Pont**, 308 U.S. 488 (1940). Income tax deductions are a matter of legislative grace, and the taxpayer has the burden of clearly showing the right to the claimed deduction.

Current Law

Section 263(a)(1) provides that no deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. See also Treas. Reg. § 1.263(a)-1(a)(1). Section 263(a)(2) prohibits a deduction for amounts expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 263A, enacted in 1986, also applies to property produced by the taxpayer for use in its business or an activity conducted for profit. For example, if a company constructs an addition to their building, § 263A requires that direct and indirect costs of construction be added to the building's basis. This includes the requirement for capitalization of construction period interest. Section 263A(g)(1) defines the term "produce" to include construct, build, install, manufacture, develop or improve.

Capitalization is the proper treatment for expenditures incurred in new construction. See §§ 263(a) and 263A. Capitalization is also generally required for additions to existing buildings or for installations of material components to buildings or equipment.

Treas. Reg. § 1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred to (1) add to the value, or substantially prolong the useful life of property owned by the taxpayer, such as plant or equipment or (2) adapt property to a new or different use. The regulation further provides that amounts paid or incurred for incidental repairs and maintenance of property within the meaning of § 162 and Treas. Reg. § 1.162-4 are not capital expenditures.

Section 162 provides a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business. Treas. Reg. § 1.162-4 provides that the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted. However, this regulation also provides that repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the useful life of the property, shall either be capitalized and depreciated in accordance with § 167 or charged against the depreciation reserve.

While an increase in value is indicative of a capital expenditure, the term value is not defined in the Code, regulations, or by case law. There is no bright line test.

Quite frequently, new additions are made to already existing property. These additions are not replacement components nor are they repairs to property, but are instead newly installed components. These additions are required to be capitalized. This requirement applies to both § 1245 and § 1250 property.

At other times, replacement parts or components are added. For example, a car's engine is worn out and replaced. This replacement returns the car back to its condition prior to the deterioration of the part. It would be logical to consider this replacement as an increase to the car's value resulting in capitalization. Conversely, it would also make sense to say that by returning the car back to its prior condition, it had been repaired. Under this theory, all repairs would be deductible under § 162(a), no matter how substantial they might be. This interpretation would render meaningless any distinction between a deductible business expense and a capital expenditure. Thus, it is oftentimes insufficient to merely look at increased value as the determinative factor for the purpose of characterizing the replacement of a part or component. An increase in value is one of many factors that must be considered to determine deductibility or capitalization. This situation was well summarized by the court in **Smith v Commissioner**, 300 F3d. 1023, 1031 (9th Cir. 2002):

Viewed in isolation, Vanalco's argument regarding Plainfield-Union's value test makes intuitive sense: any increase in property value attributed to repairs must be assessed relative to the condition of the property in its original functioning state. Otherwise, every repair would be deemed a capital expenditure since it would always be the case that a repair would enhance the value of property relative to its deteriorated condition. However, the interpretation that Vanalco proposes similarly proves too much. Clearly, any replacement of a machine's worn out part would return the machine back to its condition prior to the deterioration of the part. Under this logic, all repairs would be deductible under § 162(a), no matter how substantial they might be. Thus, replacing the engine in a car would constitute a deductible business expense to the same extent as would replacing the tires. This result would be contrary to existing precedent, see **LaSalle Trucking Co. v. Commissioner**, T.C. Memo. 1963-274 (holding that the cost of replacing a truck engine was not deductible as a repair), and would render meaningless any distinction between a business expense and capital expenditure.

Thus, it is insufficient merely to look at increased value as the determinative factor for the purposes of characterizing the cell relining costs. Instead, a court must look beyond the increased value test to other indicia of deductibility or capitalization. For instance, it is inescapable that the relative importance of a component part will play a vital role in determining whether its replacement is treated as an ordinary and necessary business expense or a capital expenditure. That is, in order to determine whether a repair is "incidental" in the sense that it is only necessary to maintain property in an efficient operating condition, the significance of the part under repair to the operation of the property is a critical inquiry.

Although the high cost of the work performed may also be considered in determining whether an expenditure is capital in nature, cost alone is not dispositive. Compare **R.R. Hensler, Inc. v. Commissioner**, 73 T.C. 168 (1979), acq. in result, 1980-2 C.B. 1, where the fact that taxpayer's expense was large did not change its character as ordinary, and **Griffin v Commissioner**, T.C. Memo 1995-404, where the installation of a trailer hitch resulted in a modification to a pick up truck in the nature of a capital expenditure.

Whether expenditures for repairs or restorations are required to be capitalized or currently deducted can better be understood through a review of current law. Rev. Rul. 2001-4, 2001-1 C.B. 295, is a good starting point as it provides a general explanation of current law for capitalization. In this Revenue Ruling, the IRS addressed three situations to determine whether a commercial airline was required to capitalize costs incurred for work performed on its aircraft and airframes. Three distinct scenarios complete with supporting law demonstrate how the purpose, physical nature and effect of the work performed will result in decidedly different tax treatments.

In scenario 1, costs incurred constitute repairs because there are no replacements of any major component or substantial structural parts. There is no increase in value or useful life; nor is the work completed under a plan of rehabilitation. The work serves to keep the airframe in an ordinarily efficient operating condition.

In scenario 2, the work performed results in an allocation of costs. The costs similar to scenario 1 are afforded treatment as a repair. However, costs incurred to rebuild a significant portion of a structural component of the aircraft and to install modifications are required to be capitalized.

The facts in scenario 3 result in capitalization of all costs incurred. This situation describes substantial improvements to an aircraft nearing the end of its useful life. The work done extends the useful life, modifies the structure, adds new components and upgrades equipment. Because an improvement constitutes production of property, § 263A(g)(1) applies and indirect costs are also required to be capitalized. In this case, the Plan of Rehabilitation Doctrine is applicable.

There is significant case law and additional guidance addressing capitalization. As stated in **American Bemberg Corp. v. Commissioner**, 10 T.C. 361, 376 (1948), **aff'd**, 177 F 2d 200 (6th Cir. 1949), "[i]t is appropriate to consider the purpose, the physical nature and the effect of the work for which the expenditures were made."

The following table summarizes many of the factual considerations considered by the courts. These factors, although not exhaustive, should be considered in your analysis to distinguish between capital expenditures and deductible repairs.

Capital	Repair
Improvements that "put" property in a better operating condition	Improvements that "keep" property in efficient operating condition
Restores the property to a "like new" condition	Restores the property to its previous condition
Addition of new or replacement components or material sub-components to property	Protects the underlying property through routine maintenance
Addition of upgrades or modifications to property	Incidental Repair to property
Enhances the value of the property in the nature of a betterment	
Extends the useful life of the property	
Improves the efficiency of the property	
Improves the quality of the property	
Increases the strength of the property	
Increases the capacity of the property	
Ameliorates a material condition or defect	
Adapts the property to a new use	
Plan of Rehabilitation Doctrine	

Improvements that Put vs. Keep Property in Efficient Operating Condition

The courts have distinguished between deductible repairs and non-deductible capital improvements based on whether the expenditure puts or keeps the property in an ordinary efficient operating condition. As stated by the Third Circuit in **Estate of Walling v. Commissioner**, 373 F.2d 190, 192-193 (3rd Cir. 1967), the relevant distinction between capital improvements and repairs is whether the expenditures were made to "put" or "keep" property in ordinary efficient operating condition. If improvements are made that 'put' the particular capital asset in efficient operating condition, then they are capital in nature. If, however, they are made merely to 'keep' the asset in efficient operating condition, they constitute repairs and are deductible." See also **Moss v. Commissioner**, 831 F.2d 833, 835 (9th Cir. 1987) (quoting Estate of Walling).

As explained in **Illinois Merchants Trust Co. v. Commissioner**, 4 B.T.A. 103, 106 (1926), acq., C.B. V-2, 2, in the determination as to whether an expenditure is a capital one, it is necessary to keep in mind the purpose for which the expenditure was made. Here the court found that the expenditures were made for the purpose of keeping the property in ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. The court went on to explain that the expenditures did not replace, alter or improve the property nor did they add to the property, appreciably prolong the life of the property, increase its value, or make it adaptable to a different use.

Restores the Property to a "Like New" Condition

In **Ruane v. Commissioner**, T.C. Memo, 1958-175, amounts expended for reconditioning coke ovens were required to be capitalized. The court stated that, "the work performed on the ovens appreciably prolonged their life and, in fact, gave them a new life." A similar conclusion was reached by the court in **Electric Energy, Inc. v. United States**, 13 Cl. Ct. 644 (1987), where the taxpayer testified that a normal operating life for an economizer was 25-30 years. After work was performed on the economizer's horizontal elements, it was expected that the economizer would last 40 or more years due to the elimination of the inherent problem of the tight spacing and the staggered arrangement. The wholesale replacement of the horizontal elements prolonged the life of the economizer requiring capitalization.

In **Hudlow v. Commissioner**, T.C. Memo 1971-218 (issue 9), the court recognized that while the cost of work performed on forklift trucks to get them operating again each time they broke down might have qualified as repair expenses; the work done in this case represented the replacement of major parts, not just to repair a breakdown, but to put the machines into such condition that they would no longer be unduly susceptible to breakdowns. These forklifts were substantially worn out and the work was in the nature of an overhaul, which served to prolong the life of the machines and to increase their value. **See also Almac's, Inc. v. Commissioner**, T.C. Memo 1961-13, (re-tubing of a boiler after 27 years extended its useful life by more than a year or two); **Phillips & Easton Supply Co. v. Commissioner**, 20 T.C. 455 (1953), (installing a new floor in the taxpayer's building was a capital expenditure where the old floor was 46 years old and had deteriorated so that further repairs were not practical); **Denver & Rio Grande W. R.R. Co. v. Commissioner**, 279 F.2d 368 (10th Cir. 1960), (substantial restoration, strengthening and improvement of a viaduct was not for incidental repairs but for a replacement of a major portion of the viaduct, which could no longer be repaired).

The Service also recognizes that costs to restore property to a like new condition must be capitalized. For example, in Rev. Rul. 88-57, 1988-2 C.B. 36, costs incurred for freight car cyclical rehabilitations constitute capital expenditures. In this ruling, a railroad established a program for cyclical rehabilitations of its freight cars. After 8 to 10 years of service, the cars were completely disassembled, inspected, and reconditioned. Essentially, the work included replacement or reconditioning of all the freight cars' structural components. According to the ruling, without these rehabilitations, the freight cars would have had a service life of 12 to 14 years. However, after the rehabilitation, the cars had a new service life of 12 to 14 additional years. With repeated rehabilitations, the cars were expected to have a service life in excess of 30 years. These rehabilitations increased the value and prolonged the useful life of the freight cars. The key distinction was that the work was done when the asset was near the end of its useful life. The work did not merely restore the property to the condition it was in prior to the repair; rather, it prolonged the useful life of the equipment another 12-14 years. In this case, the plan of rehabilitation doctrine also applied.

Restores the Property to its Previous Condition

In the case of **Plainfield-Union Water Co. v. Commissioner**, 39 T.C. 333 (1962), **nonacq**., on other grounds, 1964-2 C.B. 3, the Tax Court determined that if the expenditure merely restores the property to the state it was in before the repair was required and does not make the property more valuable, more useful, or longer-lived, it is usually considered a deductible repair. The petitioner in this case, cleaned and lined approximately one-half of one percent of its water pipelines. This work was done to repair the damage caused by acidic water flowing through a small portion of its system. With the exception of three cleanings done shortly after the introduction of this acidic water to this portion of its system, the petitioner had never before experienced a need to clean its pipelines nor afterwards was there any indication that further cleaning or relining would be needed. This work corrected the problem the petitioner was experiencing due to the acidic water. Considering the facts in this case, the court found that these costs should be treated as a repair.

The **Plainfield-Union** Test generally measures the value, use, life expectancy, strength, or capacity of the property after the expenditure with the status of the property before the condition necessitating the expenditure arose. **See also, Norwest Corp. & Subs. v. Commissioner**, 108 T.C. 265, 279-280 (1997); an expenditure that returns property to the state it was in before the situation prompting the expenditure arose is usually deemed a deductible repair. A capital expenditure is generally considered to be a more permanent improvement in the longevity, utility, or worth of the property, **Smith v. Commissioner**, 300 F.3d 1023 (9th Cir. 2002).

Addition of New or Replacement Components or Material Sub-Components

When new §§ 1245 or 1250 property is added to already existing property, capitalization is required. So too, when replacement components or material sub-components are installed, these costs generally must be capitalized.

For example, In **Smith v Commissione**r, 300 F 3d 1023 (9th Cir. 2002), the court concluded that the replacement of the aluminum smelting cell lining was a replacement of an essential component of the cell, extending the life of the cell and requiring capitalization. Also, adding new building components that improve utility are capital. See **R.K.O. Theatres, Inc. v. United States**, 163 F.Supp. 598 (Ct.Cl. 1958), where the court opined that new fire doors and escapes added to a theater increased the value of the property for use in taxpayer's theatre business and thus were capital improvements; **Hotel Sulgrave, Inc. v. Commissioner**, 21 T.C. 619 (1954), where the court found that an expenditure for a new fire sprinkler system to comply with a city order was capital because it gave an apartment building additional protection resulting in an improvement or betterment with a life extending beyond the year in which it was made. The court went on to point out that even though neither the value of the property nor its useful life increased, the property became more valuable for use (in the taxpayer's business) by reason of compliance with the city's order.

Extensive case law deals with building improvements to comply with governmental requirements. These cases conclude that capital expenditures made to comply with government regulations (e.g., a city ordinance) are not rendered deductible merely because they are not voluntary. See, **Blue Creek Coal, Inc. v. Commissioner**, T.C. Memo.1984-579; **Swig Investment Co. v. United States**, U.S., 98 F.3d 1359 (Fed. Cir. 1996); **Trenton-New Brunswick Theatres Co. v. Commissioner**, T.C. Memo 1954-69; **Teitelbaum v. Commissioner**, 294 F.2d 541 (7th Cir. 1961).

The costs of adding, replacing and installing new components and structural parts generally must be capitalized. The subject of components and structural parts is discussed in Appendix C – Unit of Property.

Addition of Upgrades or Modifications

Similar to the addition of new components or structural parts, replacing existing components with upgraded components (or sub components) that improve utility requires capitalization. See **Smith v. Commissioner**, 300 F.3d 1023 (9th Cir. 2002), where the court found that expenditures for the replacement of substantial parts of a brick floor with cement in cell rooms were capital because the cement provided a substantial functional improvement because it was superior to brick. The court also found a material increase in the value of the floors as a whole.

In **Portland Gasoline Co. v. Commissioner**, 8 T.C.M. (CCH) 449 (1949), **aff'd** on other **issues**, 181 F.2d 538 (5th Cir. 1950), amounts expended on a steam condensing tower were required to be capitalized. "The substance of petitioner's argument on this question is that the expenditure was used in repairing a cooling tower and that 'the condenser section repaired did not constitute an addition to the plant, nor did it materially add to the value of the plant, nor did it prolong its useful life but only maintained the plant in ordinary operating condition.'" The court found that the expenditure in question was for replacing the steam condensing sections (8 or 9 out of 10 or 12) on a steam condensing tower and therefore, constituted a capital expenditure. See also Electric Energy, Inc. v. United States, 13 Cl. Ct. 644 (1987), which required that the taxpayer capitalize costs of replacing horizontal elements that were part of economizers in taxpayer's boilers; **Jacks v. Commissioner**, T.C. Memo 1988-237, where costs of a rebuilt CAT loader engine were considered capital expenditures, but the cost of the used transmission was deductible; **West Virginia Steel Corp. v. Commissioner**, 34 T.C. 851 (1960), requiring the taxpayer to capitalize costs of replacing an old engine in a delivery vehicle; Rev. Rul. 72-507, 1972-2 C.B. 198, holding that costs of replacing nuclear fuel elements used to power nuclear reactor plants were capital expenditures; and Rev Rul. 2001-4, 2001-1 C.B. 295, where the replacements of skin panels were required to be capitalized.

Protects the Underlying Expenditure through Routine Maintenance

In applying the put versus keep standard, the court in **Ingram Industries, Inc. v. Commissioner**, T.C. Memo 2000-323, looked at the condition of a tug boat engine prior to the maintenance work performed. It contrasted the inspection and maintenance of the engines to an overhaul of the engines. It differentiated between work performed on a scheduled basis which was clearly to keep the engine in operating condition, with work performed on a non functioning engine, such as overhaul or replacement, which was designed to put the engine and boat back into operating condition.

It is important to understand that although the Service sought to classify the work performed in **Ingram** as an overhaul of the engine, the court specifically found that the facts did not support this characterization. Rather, the court determined that the procedure at issue was more in the nature of preventative maintenance. In fact, the court specifically distinguished the procedure before it, from a procedure known as a towboat "re-powering," during which the engine is removed from the hull for a "complete overhaul." A re-powering procedure takes 3 to 5 months, costs $200,000 (which would be 3% of the cost of a new towboat, 9% of the cost of a used towboat, 13% of the cost of a new engine, and 33% of the cost of a used engine), is performed near the end of the engine's useful life and brings each engine component part back to original specifications for new parts. Though not specifically stated, the court implies that expenses for such a complete "re-powering" would be capital rather than currently deductible. The taxpayer in **Ingram** conceded that re-powering expenses should be treated as capital costs; only the in boat procedure was before the court.

In Rev. Rul. 2001-4 (situation 1), heavy maintenance visits for aircraft, to inspect, test, service, repair, recondition, clean and repaint their airframe, including their parts and components that keep the airframe in ordinarily efficient operating condition are currently deductible. The repairs merely protected the underlying property and did not rise to the level of a restoration of property which would require capitalization. Contrast situation 3, where the facts have changed from those supporting a deduction for routine maintenance to circumstances describing a material increase in value and substantial prolonging of useful life of property requiring capitalization.

Incidental Repair to the Property

The costs of incidental repairs are typically deductible. The regulations state that the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient condition, may be deducted as an expense. Repairs in the nature of replacements however, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with § 167 or charged against the depreciation reserve if such an account is kept. A detailed consideration of all the circumstances surrounding a repair must be made to determine whether the repair is a business expense or capital expenditure.

Enhances the Value of the Property in the Nature of a Betterment

Expenditures enhancing the value of property constitute betterments to the property and must be capitalized. In **Nelson v. Commissioner**, 184 F.2d 649 (8th Cir.1950), the taxpayer made improvements to his office which was occupied under a lease. The court noted the improvements were attached to the realty and became permanent fixtures which had a useful life of several years. The court held that the improvement constituted a capital expenditure because it was in the nature of a betterment and hence not deductible as a business expense.

A similar conclusion was reached in **G. & R. Corp. v. Commissioner**, 8 T.C.M. (CCH) 970, (1949), where the business advantage of installing new floors would be realized by the petitioner in future years. The new floors rendered the building better suited for taxpayer's purposes. The court had no trouble concluding that a prospective purchaser would pay more for a building immediately after new oak floors had been installed.

Similarly, in **Lombardo v. Commissioner**, T.C. Memo 1979-11; **aff'd per curiam** on other **issues**, **Cracchiola v. Commissioner**, 643 F.2d 1383 (9th Cir.1981), the Tax Court held that expenditures that petitioners claimed were deductible rental expenses were paid to renovate an apartment in a rental property. To modernize one apartment, the taxpayer had the walls of the apartment torn out, put new electrical wiring and fixtures into the walls, installed new plumbing and put in new flooring, new walls, and new cabinets. The court concluded that the expenditures were capital in nature because they were for permanent improvement that enhanced the value of the property.

Extends the Useful Life of the Property

Extending the useful life of property is a common justification for capitalization. For example, in **LaSalle Trucking Co. v Commissioner**, T.C. Memo 1963-274, the court found that amounts expended for the replacement of engines, petroleum tanks and truck cabs extended the life of the trucks. The replacement cab and the replacement petroleum tank last approximately 6 years and the engine last several years according to testimony. The value and life of the trucks were increased by the installation of these new components.

In **Jacks v. Commissioner**, T.C. Memo 1988-237, a rebuilt engine installed on a CAT loader truck extended the useful life of the vehicle. The court found that the benefits associated with the rebuilt engine would accrue to the taxpayer over a number of years and it was appropriate that the related costs be capitalized and recovered over a similar period. In **Tsakopoulos v. Commissioner**, T.C. Memo 2002-8, **aff'd** on a**nother issue without published opinion**, 2003-1 USTC ¶ 50,513 (9th Cir. 2003), the court stated that the cost of the work performed on the roof must be capitalized because of the substantial nature of the work done and the work appreciably prolonged the useful life of the roof.

When evaluating whether the useful life of the property has been prolonged, the courts generally consider an increase in useful life of 1 year or more a material increase. In **Atlas Storage Co. v. United States**, 306 F.Supp., 570, 582-583 (D.C.W. Va.1969), **aff'd** on **another issue**, 437 F 2d 1319 (4th Cir. 1971), the court, quoting **Tidwell v. Commissioner**., 298 F.2d 864 (4th Cir. 1962), stated that if "the expenditure is made for the acquisition of an asset that has a useful life in excess of one year, it is normally treated as a capital expenditure and cannot be deducted as a business expense. On the other hand, if the asset so acquired has a useful life of less than one year its cost is ordinarily deductible under § 162."

Improves the Efficiency of the Property

Increased future operating efficiencies are a future benefit to be taken into account in determining if a cost is capital. This was recognized by the Supreme Court in **INDOPCO, Inc. v. Commissioner**, 503 U.S. 79 (1992).

In **Electric Energy, Inc. v. United States**, 13 Cl. Ct. 644 (1987), the court found that when the taxpayer added an economizer to their coal-firing boiler, the unit's overall efficiency was improved. While the improvement in efficiency was not a determining factor, the court did find that improvement of pre-existing equipment is suggestive of capitalization.

In **West Virginia Steel Corp. v. Commissioner**, 34 T.C. 851 (1960), some machines were moved to an area which had previously been used for storage, which necessitated extending the wiring to that area. The rewiring adapted petitioner's property to its business and constituted a substantial change in the electrical system of the plant. The expenditure for such electrical rewiring constituted a capital outlay and not a current expense. The petitioner stated that such rewiring was a recurring necessity because of the changing requirements of its contract business. However, the evidence indicated that the rewiring in question represented a permanent change and improvement in the production facilities. These changes resulted in an increase in efficiency to the taxpayers business and were required to be capitalized.

Improves the Quality of the Property

In **Craig v. Commissioner**, 7 T.C.M. (CCH) 532 (1948), the court found that while the petitioner made no structural changes during a roof repair and did not remove the old shingles, the fact that they resurfaced the wooden shingle roof by covering it with a new composition shingle roof provided the distinction between a deductible repair and a nondeductible improvement. In this case, the new composition shingled roof improved the quality of the old wooden shingled roof.

In **Black Hardware Co. v. Commissioner**, 39 F.2d 460 (5th Cir. 1930), the court found that costs to raise the floor level, even if they did not increase the building's value were permanent betterments and improvements that rendered the building better suited to the purpose for which it was used and therefore, had to be capitalized. See also, Amsterdam Theatres Corp. v. Commissioner, 24 B.T.A. 1161 (1931).

Increases the Strength of the Property

In the case of, **Swig Investment Co. v. United States**, 98 F.3d 1359 (Fed. Cir. 1996), the court in an unpublished opinion, found that new parapets and cornices, which were made of different material with different fastening and additional steel, significantly improved the structural soundness of the hotel and had to be capitalized. The costs increased the value of the building and extended its useful live.

A similar decision was reached in **Levy v. Commissioner**, 212 F.2d 552, (5th Cir.1954), where the cost of completely encasing wooden trusses of roof supports in steel plates, replacing a substantial portion of the roof, and installing new flooring and new interior features were found to be capital because the repairs materially added to the property's value and extended its life.

Increases the Capacity of the Property

In **Mennuto v Commissioner** 56 T.C. 910 (1971), the Tax Court required the taxpayer to capitalize the cost of replacing 1½-inch piping, used to supply a factory with water, with 2-inch piping because the new piping was more efficient and increased the factory's water supply. Similarly in **Scovill Manufacturing Co. v. Commissioner**, 25 B.T.A. 265 (1932), work done on a dam was found to be an improvement. The taxpayer did not merely repair the dam but worked on the reservoir to insure an adequate supply of water into the future. The court found that these repairs increased the capacity of the reservoir and resulted in an increased and continuing supply of water.

Ameliorates a Material Condition or Defect

The courts have ruled that in cases involving the amelioration of a material condition or defect that either existed prior to the taxpayer's acquisition of the UOP or that arose during the production of the UOP, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production, must be capitalized. In **Stoeltzing v. Commissioner**, 266 F.2d 374 (3rd Cir. 1959), the Appeals Court affirmed that in substance, the work performed by the taxpayer to bring its recently purchased building back to a tenantable condition was no different than work the taxpayer may have undertaken had they chosen to erect a completely new building.

In **United Dairy Farmers, Inc. v. Commissioner**, 267 F.3d 510 (6th Cir. 2001), the taxpayer was denied a §162 deduction associated with soil remediation because the corporation purchased the stores with the contamination defect already in place, and the corporation did not contaminate the properties in the ordinary course of its business. Compare **Cinergy Corp. v. Commissioner**, 55 Fed Cl. 489 (2003), where the court determined that the asbestos problem did not arise when the building was constructed, but rather, over time during the ordinary operation of the office building. The "asbestos containment costs" were deductible.

Adapts the Property to a New Use

In **Difco Laboratories, Inc. v. Commissioner**, 10 T.C. 660 (1948), the court held that the expenditures for lowering one basement room to the level of another basement room, along with other alterations connected therewith, to facilitate the wheeling of trucks from one room to the other, adapted the basement for a different use and were therefore capital expenditures.

In **Popular Dry Goods Co. v. Commissioner**, 6 B.T.A. 78, 83 (1927), the court stated, "The expenditures on the annex, or Hammett and Bassett properties, were principally for the conversion of those properties into an operating unit. They were not for repairs but for alterations which made the properties adaptable to a different use. Expenditures for such alterations, although they do not increase the value of the property, are not deductible from gross income."

In **Bee Holding Co. v. Commissioner**, T.C. Memo 1958-195, the Tax Court determined that expenditures incurred by a building owner for converting three storerooms in the building into one larger storeroom were capital expenditures. The court found these expenditures were made to adapt property to a different use. The work consisted of breaking down walls, replacing lighting and heating units, adding new plumbing, adding new sidewalk, and constructing an additional rear entrance. Similarly, in **Burbank v. Commissioner**, 3 B.T.A. 1118

(1926), the cost of converting three small store rooms on the first floor of the taxpayer's building into a single large room was held to be a capital expenditure.

Plan of Rehabilitation Doctrine

Section 263A requires that all direct costs of property produced, which includes an improvement and all indirect costs that directly benefit or are incurred by reason of the production (improvement) must be capitalized. See § 263A(b), which states that § 263A applies to real or tangible property produced by the taxpayer, and § 263A(g)(1), which states that the definition of "produce" includes improve. See also Treas. Reg. § 1.263A-1(e), which requires the capitalization of direct costs and of all indirect costs that directly benefit or are incurred by reason of the performance of production activities. Section 263A, therefore, requires a taxpayer to capitalize otherwise deductible repair costs as part of an improvement if the taxpayer improves a UOP and the otherwise deductible repair costs directly benefit or are incurred by reason of the improvement to the property.

The characterization of any cost as a deductible repair or capital improvement depends on the context in which the cost is incurred. Specifically, where an expenditure is made as part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the expenditure might be classified as repair or maintenance.

Whether a general plan of rehabilitation exists, and whether a particular repair or maintenance item is part of it, are questions of fact to be determined based upon all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done. The existence of a written plan, by itself, is not sufficient to trigger the plan of rehabilitation doctrine.

In **United States v. Wehrli**, 400 F.2d 686, (10th Cir. 1968), the court stated that the evidence in the case certainly weighed in favor of a general plan of rehabilitation such that expenditures for incidental repairs and replacements in connection with the alteration and refurbishing of an office building for a new tenant should be capitalized. See also, Rev. Rul. 2001-4, 2000-1 C.B. 295, (situation 3), where otherwise deductible expenditures are required to be capitalized based on both the plan of rehabilitation and § 263A.

Unanticipated expenses that are otherwise deductible must be capitalized when incurred pursuant to a plan of rehabilitation. In **California Casket Co. v. Commissioner**, 19 T.C. 32 (1952), the court held that expenditures for incidental repairs and replacements done with respect to a plan to reconstruct an old warehouse into a modern plant represented expenditures that were properly capitalized rather than deducted currently as a separate repair expense. In **Norwest Corp. v. Commissioner**, 108 TC 265, (1997), the Tax Court required that the taxpayer must capitalize the costs of removing asbestos-containing materials from its building because they were part of one intertwined remodeling entailing a general plan of rehabilitation to remodel and renovate its bank building. The Tax Court stated that "an asset need not be completely out of service or in total disrepair for the general plan of rehabilitation or improvement doctrine to apply." Id at 280.

In **Bank of Houston v. Commissioner**, T.C. Memo 1960-110, the taxpayer's 50-year-old building was in a general state of disrepair but still serviceable for the purposes used (before, during, and after the work) and was in good structural condition. The taxpayer hired a contractor to perform the renovation which included nonstructural repairs to flooring, electrical wiring, plaster, window frames, patched brick, and paint, as well as plumbing repairs, demolition, and cleanup. The court recognized that each phase of the remodeling project, removed in time and context, might be considered a repair item, but stated that the Code does not envision breaking-up an overall capital project. The court held that the expenditures were not made for incidental repairs but were part of an overall plan of rehabilitation, restoration, and improvement of the building.

In, **Rutter v. Commissioner**, T.C. Memo 1986-407, aff'd on other issues, 853 F.2nd 1267 (5th Cir. 1988), the court held that the addition of a lunch area, restrooms, and a loading ramp to existing plants resulted in an improvement. Since these changes were made as part of an overall capital investment and were not segregated from other costs such as painting which would normally be deductible, all the costs were required to be capitalized.

The question as to whether the plan of rehabilitation applies when there is a mix of improvements as well as repairs is a question of fact. In certain cases, the courts have found that the facts do not support a general plan of rehabilitation, modernization or improvement. In these cases, the courts allow deductions for portions of the expenditures while requiring capitalization for others.

In **Keller Street Dev. Co. v. Commissioner**, 37 T.C. 559, 568 (1961), **aff'd in part** and **rev'd in part on other grounds**, 323 F.2d 166 (9th Cir. 1963), the taxpayer, a brewery, had made some capital improvements to plant and equipment, most of which were designed to increase productive capacity so it could fill increasing demand. The Commissioner argued that certain of the expenditures were repairs that were part of a general betterment program, and therefore, should be capitalized even though if viewed individually they would be deductible as ordinary and necessary expenses. However, the court declined to apply the rehabilitation doctrine because "the brewery was in operating condition and use during the taxable years in question and had been for several years before." It also found that the "capital improvements made to increase capacity [were] not such as would constitute a general betterment program," and that the few other capital improvements made by the taxpayer "were of the type that must be constantly made by a manufacturer in a competitive industry and therefore [are] not to be considered part of a betterment program." Keller Street, 37 T.C. at 568.

The existence of a written plan, by itself, is not sufficient to trigger the plan of rehabilitation doctrine. See **Moss v. Commissioner**, 831 F.2d at 833 (9th Cir. 1987). The courts and the IRS have not applied the plan of rehabilitation doctrine to situations where the plan did not include substantial capital improvements and repairs to the same asset, the plan primarily involved repair and maintenance items, or the work was performed merely to keep the property in an ordinarily efficient operating condition. In Moss, the hotel remodel did not include capital improvements and repairs to the hotel building. Rather, the capital improvements were for personal property replacements only (new beds, chairs, tables, lamps, carpeting, drapes, bedspreads, dining and kitchen furnishings, and office equipment) and the work on the hotel building was repair and maintenance work only (including repainting and wall coverings). The court also stated that the hotel was in very good operating condition and remained in operation throughout the period of remodeling, which, while not dispositive, supported the conclusion that the taxpayer's plan was consistent with the type of annual maintenance activities necessary to maintain the hotel in first class condition.

Conclusion

Courts weigh many factors when considering whether an expenditure is required to be capitalized or should be afforded treatment as a current deduction. These decisive distinctions require careful examination of the facts and circumstances in each case. When an examining agent considers whether an expenditure previously capitalized by a taxpayer, should now be treated as a deductible expense under a Change in Accounting Method, the burden is on the taxpayer to clearly demonstrate a right to the deduction claimed.

For questions regarding tangibles capitalization please contact the Capitalization Technical Advisors.

APPENDIX C: UNIT OF PROPERTY (UOP)

In General

A threshold issue in applying the guidelines under §§ 162 and 263(a) is determining the appropriate UOP to which the guidelines should be applied. For example, to determine whether an expenditure materially adds value to property, the "property" must be determined. The smaller the UOP, the more likely it is that costs incurred in connection with that UOP will have to be capitalized. Thus, taxpayers and the Service frequently disagree on the UOP to which the capitalization rules should be applied.

The concept of UOP is addressed in other Code sections. These include § 263A(f) for purposes of interest capitalization (see Treas. Reg. § 1.263A-10; Treas. Reg. § 1.165-7(b) for purposes of determining single, identifiable property (SIP) for casualty losses; and Treas. Reg. § 1.167(a)-11(d)(2)(vi) for the repair allowance rules). None of these UOP definitions specifically apply under § 263(a) , and neither the Service nor the courts have used these definitions to define a § 263(a) UOP. Thus, we must look elsewhere for guidance in addressing UOP under § 263(a).

Determination of UOP under Current Law - in General

As stated above, the current regulations do not define "property" for purposes of determining whether an amount adds value to the property, prolongs the useful life of the property, or adapts the property to a new or different use. Historically, the courts have managed to evaluate the repairs versus capitalization issue without directly addressing the UOP. In recent years however, a few courts have directly addressed the issue.

Determination of UOP under Current Law for Personal Property

In **Ingram Industries, Inc. v. Commissioner**, T.C. Memo 2000-323, the court addressed whether the costs of cleaning, inspecting, and repairing towboat engines were capital expenditures. The Service focused on the engines and argued that the work performed increased the value and prolonged the useful life of the engines. The taxpayer argued that the appropriate focus was on the towboat, and the court agreed, stating that the record did not support a practice (industry or otherwise) to purchase or treat towboat engines separately from the towboats. The court reasoned that the towboats and engines, if properly maintained, were both expected to last 40 years, that the towboats were purchased with the engines, and that the engines were designed to be maintained without removing them from the boat. The court also noted that there was no evidence indicating that towboat owners regularly and periodically replaced the towboat engines. Ultimately, the court held that the expenditures did not increase the value or useful life of the towboat or the engine and could be deducted.

In **FedEx Corp. v. United States**, 291 F.Supp. 2d 699 (W.D. Tenn. 2003), **aff'd**, 412 F.3d 617 (6th Cir. 2005), the court ruled on whether an aircraft engine or the entire aircraft was the appropriate UOP for determining whether the costs of servicing engines must be treated as capital expenditures. Relying on the opinions in Ingram and Smith (discussed below) which also dealt with personal property as defined in § 1245, the court concluded that the following four factors are relevant in determining the appropriate UOP: (1) whether the taxpayer and the industry treat the component part as a part of a larger UOP for regulatory, market, management, or accounting purposes; (2) whether the economic useful life of the component part is coextensive with the economic useful life of the larger UOP; (3) whether the larger UOP and the smaller UOP can function without each other; and (4) whether the component part can be and is maintained while affixed to the larger UOP.

Applying these factors to aircraft engines, the court concluded that the engines should not be considered a UOP separate and apart from the airplane. Specifically, the court found probative that "airplane" was defined by the Federal Aviation Authority to include the engines and the airframe, that the airplanes were appraised with their engines, that the engines and airframes were acquired by the taxpayer at the same time and as one unit, that maintenance on the taxpayer's engines and airframes was governed by a single department and a unified maintenance plan, that the engines and airframes were expected to have the same economic life of approximately 30 years, and that neither the engines nor the airframe could function as an airplane without each other. On the other hand, the court did not place significant weight on the fact that the engines were removed from the airframe for maintenance and replaced with previously repaired engines. The court held that the taxpayer was not required to capitalize the costs of its engine service costs because they did not increase the value or life of the aircraft.

A few other courts also have addressed the UOP question for personal property basing their findings on case specific facts. In **LaSalle Trucking Co. v. Commissioner**, T.C. Memo 1963-274, the court found that there was considerable evidence that engines, tanks, and cabs of petroleum hauling trucks were independent capital assets. Specifically, the court pointed to the fact that each item had a useful life in excess of one year, was of an interchangeable nature, and was on occasion treated as a substitute or standby component. The court also found it difficult to believe that the life of the truck was not extended and its value not increased by the installation of a new engine, cab, and tank. In **Jacks v. Commissioner**, T.C. Memo 1988-237, the court treated the CAT loader, rather than the engine, as the UOP. The overhaul of an engine however was treated as capital because it extended the life of the CAT loader. See also **Hudlow v. Commissioner**, T.C. Memo 1971-218, where the replacement of major parts in a forklift truck were in the nature of an overhaul, which increased the life and value of the truck and had to be capitalized and Rev. Rul. 2001-4, 2001-1 C.B. 295, where the Service looked to the airframe, rather than the entire aircraft, to determine whether costs of heavy maintenance visits were capital expenditures or deductible business expenses.

Determination of UOP under Current Law for Plant Property

Several courts have considered the question of UOP for "plant property" assets. In **Smith v. Commissioner**, 300 F.3d 1023 (9th Cir. 2002), the court required the taxpayer to capitalize the costs of replacing the linings of aluminum reduction cells in an aluminum smelting plant. Although the taxpayer's design required a minimum of 112 functioning cells (out of 650) to operate the plant on a sustained basis, each cell could independently produce aluminum. In addition, the cells were essentially interchangeable; they could each be withdrawn from the cell line for repair and replaced with a different cell. The taxpayer argued that the entire cell line, as opposed to each individual cell, was the appropriate UOP. The court found that the cells were "sufficiently free-standing to constitute property separate and apart from the interconnected cell line." Thus, the court concluded that the cell, rather than the entire cell line, was the relevant UOP, and the taxpayer was required to capitalize the costs of replacing the cell linings.

In **Electric Energy Inc. v. United States**, 13 Cl. Ct. 644 (1987), the Claims Court specifically focused on the UOP issue in the context of an electric generating plant. The court examined whether the taxpayer was permitted to deduct the costs of replacing the horizontal tubing in the economizer section of a boiler.

The boiler is used to generate steam in the taxpayer's power plant. The economizer is a walled part of the boiler through which the discharged hot gases produced by the boiler are released after the principal part of their heat has been used to produce steam. The economizer uses the hot gases to preheat the water being returned to the boiler from the turbine. It is considered an add-on item that, when attached to the boiler, improves the boiler's overall efficiency.

The taxpayer argued that the economizer was not a UOP because it could not operate alone. The taxpayer also contended that although replacement of the tubing in the economizer might extend the life of the economizer, it did not prolong the life or enhance the function of the boiler.

The court disagreed with the taxpayer and concluded that the economizer was the appropriate UOP. The court noted that under the heading of boilers the taxpayer's property catalog listed economizers as distinct UOPs. Further, the court stressed that the economizers were not vital to the boiler's production of steam. The boiler could produce steam on its own. The economizer served the separate function of enhancing the unit's ability to convert water to steam (preheating the water). Thus, the court concluded that an economizer was the applicable UOP. See also **Berkley Machine Works & Foundry Co. v. Commissioner**, T.C. Memo 1977-177, where a furnace shell was considered a separate UOP from a larger machine and **Almac's Inc. v. Commissioner**, T.C. Memo 1961-13, where the re-tubing of a boiler after 27 years had extended the boiler's useful life.

While each of the aforementioned cases specifically discussed and identified the UOP, many other courts have ruled on the issue of capitalization without directly commenting on the appropriate UOP.

Determination of UOP for Buildings under Current Law

Currently, many taxpayers are taking the position that no permanent improvement resulted from work performed on buildings because the work only affected a small portion of the entire building, and the taxpayer claims the entire building is the UOP. For example, some taxpayers claimed deductions for installing new roofs, replacing heating and air conditioning systems, and making major structural changes to building interiors, because when compared to the building and its structural components as a whole, these projects could be portrayed as immaterial.

Generally, when it comes to buildings, the courts have not addressed the criteria for determining the UOP for capitalization purposes. Instead, the courts have engaged in results-driven analyses. Thus, in cases that address whether the costs of replacing structural components of buildings must be capitalized, the courts have utilized inconsistent approaches.

In some cases, the courts have looked to the entire building in determining whether there has been an improvement. In the case of **Oberman Mfg. Co. v. Commissioner**, 47 T.C. 471 (1967), the court concluded that the replacement of roofing materials and an expansion joint did not add value or prolong the useful life of the building. In **Boddie v. Commissioner**, T.C. Memo 1961-72, the court held that the replacement of a furnace and a heating system were replacements of exhausted parts of the taxpayer's rental property and were required to be capitalized. Finally, in **Buckland v. United States**, 66 F.Supp. 681, 683 (D. Conn.1946), the court stated: "If the substitution is of a major unit or structural part of the nature of a floor, wall or roof, or large part thereof, so that **the building as a whole** may be considered to have gained appreciably in expectancy of useful life, it is a substitution so great in degree that we may well place it on the 'replacement' side of the line."

In other cases, the courts have looked to specific structural components as comprising separate UOP. For example, in **Tsakopoulos v. Commissioner**, T.C. Memo 2002-8, the court stated that costs incurred to replace part of a shopping center roof were capital expenditures because the work appreciably prolonged the life of the roof. In **Hill v. Commissione**r, T.C. Memo 1983-112, the court held that costs of a new water heater and a furnace were capital expenditures because they were properties having useful lives substantially beyond the taxable year.

Until further guidance is published concerning the definition of UOP for capitalization purposes, the inconsistent court decisions provide the only substantive guidance. Thus, each taxpayer's facts and circumstances must be analyzed closely to determine the appropriate UOP for a building or its structural components.

Other UOP Considerations

Even though §§ 162 and 263(a) are silent on the definition of UOP, the aforementioned court cases dealing with personal property and plant property provide us with a number of factors that may be considered for this determination. These factors include:

1. Whether the property is manufactured, marketed, or purchased separately;
2. Whether the property is treated as a separate unit by a regulatory agency, in industry practice, or by the taxpayer in its books and records;
3. Whether the property is designed to be easily removed from a larger assembly, is regularly or periodically replaced, or is one of a fungible set of interchangeable or rotable assets;
4. Whether the property must be removed from a larger assembly to be fixed or improved;
5. Whether the property has a different economic life than the larger assembly;
6. Whether the property is subject to a separate warranty; and
7. Whether the property serves a discrete purpose or functions independently from a larger assembly.

As addressed in Appendix A of this guide, if a taxpayer has filed for a change in accounting method in order to treat property as a separate UOP for purposes of MACRS, then that property must continue to be treated as a separate UOP for capitalization purposes. If a component part is treated as a separate UOP and depreciated over a shorter recovery period, the taxpayer must continue to follow that method of accounting. This result is consistent with the taxpayer's method of accounting.

For further information regarding the review and examination of Cost Segregation Studies, industry specific guidance, and whether an asset is § 1245 or § 1250 property, please refer to the Cost Segregation Audit Technique Guide.

APPENDIX D: DISPOSITIONS

As described in Appendix A, many of the change in method of accounting requests seeking to change the definition of UOP fail to properly account for prior retirements when assets are reclassified as larger UOPs. This omission has led to the reduction of many § 481(a) adjustments on examination and, in some cases, the complete withdrawal of their change in method request.

In addition to a disregard for retirement losses, many taxpayers have failed to recognize the impact of gain or loss on other dispositions, for example in a leasing context. The impact on the change to the defined UOP on like-kind exchanges is also a potential issue to be addressed by the field in cases where the smaller UOP is now reclassified as a larger UOP thereby jeopardizing the deferral.

While some taxpayers have properly requested these change in accounting methods on separately filed Forms 3115, others have included these changes as an adjustment offsetting the § 481(a) computation for repairs. No matter the vehicle, in any review of a method change for capital to repair expense treatment, it is imperative that the examiner determine whether the taxpayer has properly accounted for dispositions and like-kind exchanges.

Types of Dispositions

It is important to recognize that the term "disposition" describes many different types of transactions, some of which are afforded special treatment under the Internal Revenue Code. A **disposition** is defined as the permanent withdrawal of depreciable property from use in a business or in the production of income. This withdrawal can be by sale, exchange, retirement, abandonment, an involuntary conversion or the destruction of depreciable property. The withdrawal of the asset also may be accomplished without disposition (i.e. by placing the asset in a supplies or scrap account). Dispositions do not include assets removed from one group account and transferred to another.

The **abandonment** of property occurs when possession and use of the property are voluntarily and permanently given up and the property is no longer useful to the owner or to anyone else. Where an asset is retired by actual physical abandonment (for example, in the case of a building condemned as unfit for further occupancy or other use), loss is measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be to irrevocably discard the asset so that the asset will not be used again by the taxpayer nor retrieved for sale, exchange, or other disposition. See Treas. Reg. § 1.167(a)-8(a)(4).

An **involuntary conversion** occurs when property is destroyed, stolen, condemned, or disposed of under the threat of condemnation and other property or money is received in payment, such as through insurance or a condemnation award. See § 1033(a).

Section 280B provides that, in the case of the **demolitio**n of any structure, no deduction shall be allowed to the owner or lessee of such structure for any amount expended for the demolition or any loss sustained on account of such demolition. Rather, the demolition costs must be added to the basis of the underlying land. A structure for purposes of § 280B is defined as a building and the structural components of that building. See Treas. Reg. § 1.280B-1(b). Section 280B does not apply to losses that occur before a structure is demolished.

Rev. Proc. 95-27, 1995-1 C.B. 704, provides a safe harbor for structural modifications to a building. This safe harbor method provides that a modification of a building, other than a certified historic structure as defined in § 47(c)(3), will not be treated as a demolition for purposes of § 280B if: (1) 75% or more of the existing external walls of the building are retained in place as internal or external walls; and (2) 75% or more of the existing internal structural framework of the building remains in place. The modification of a building that meets these criteria is not considered a demolition.

Dispositions of Property in General

Whether the costs of the removal and replacement of a disposed component of an asset are required to be capitalized under § 263(a) or are current deductions under § 162 depends on the facts and circumstances surrounding the disposition.

The Service found in Rev. Rul. 2000-7, 2000-1 C.B. 712, that the disposition costs incurred in the removal of telephone poles A and B did not require capitalization under §§ 263(a) or 263A as part of the cost of the replacement asset. The Service cautioned however, that its analysis did not apply to the removal of a component of a depreciable asset, the costs of which were either deductible or capitalized based on whether replacement of the component was a repair or improvement.

In contrast, when a major component or a substantial structural part of an asset is replaced and, as a result, the asset as a whole increases in value, life expectancy, or use, then removal and replacement costs must be capitalized. **See, e.g., P. Dougherty Co. v Commissioner**, 159 F.2d 269 (4th Cir. 1947) (holding that the costs to replace an entire stern section of barge with new materials were capital expenditures); **Vanalco, Inc. v Commissioner**, T.C. Memo. 1999-265 (holding that the costs to replace the cell lining, an essential and substantial component of the cell, were required to be capitalized); Rev. Rul. 2001-4, 2001-1 C.B. 295 (holding that the costs to replace all skin panels on the belly of airplane fuselage, a substantial structural part of airframe, were required to be capitalized).

This distinction may be illustrated by considering the removal of an old underground storage tank (a major component of a gas station's fuel distribution system, and not a separate, depreciable asset) in order to replace it with a new tank. The costs to remove the concrete or paving material, the costs of excavating soil to gain access to the old tank, and the costs to lift the old tank out of the hole must be capitalized under § 263(a). However, the costs of cleaning and disposing of the old tank are currently deductible as business expenses under § 162. Taxpayers dispose of underground storage tanks in the ordinary course of their business. The costs of cleaning and disposing of the tank are not incident to the creation of a capital asset and do not themselves create or enhance a capital asset or create significant long-term benefits. Therefore, the costs of cleaning and disposing of the old underground storage tank constitute business expenses deductible under § 162.

When assets are replaced and a loss is claimed upon disposition, reclassifying the replacement assets as part of a change in accounting method for repairs is not appropriate. In this situation, the replacement assets must be capitalized.

For example, in 2006 a taxpayer replaced an economizer which for tax purposes they treated as an asset separate from the boiler. The taxpayer claimed a loss for the remaining basis in the economizer and for the costs of disposal.

Then, in 2010 the taxpayer files a CAM seeking to reclassify repairs based on a new definition of UOP. Under the new method, the taxpayer considers the economizer to be part of a larger UOP, which includes the attached boiler. The taxpayer now wants to deduct the replacement cost of the economizer as a repair. However, because in 2007, the economizer was removed, disposed of and replaced with a new unit, a repair of the old unit is not possible. Rather, the new economizer must be capitalized.

Transactions involving dispositions where gain or loss was recognized in a prior year or where a like-kind exchange was deferred must also be considered when the assets involved are now subject to the request for CAM determination of UOP. See Treas. Reg. § 1.167(a)-8(a).

Dispositions of Structural Components of a Building

For buildings placed in service prior to 1981, a taxpayer was permitted to use component depreciation or composite depreciation. Under component depreciation, a taxpayer allocated the cost of a building to its basic component parts and then assigned a separate useful life to each of these components. S. Rep. No. 97-144

(1981), 1981-2 C.B. 412, 422. Components include the basic building shell, wiring, plumbing, roof, and other identifiable components. Each of the component parts was depreciated as a separate item of property. Under composite depreciation, a taxpayer assigned a single useful life for the building and all of its structural components.

The Economic Recovery Tax Act of 1981 (ERTA) replaced the pre-1981 system of depreciation with the Accelerated Cost Recovery System (ACRS) for determining depreciation for tangible property placed in service after 1980. Under ACRS (former § 168), component depreciation for buildings was eliminated and composite depreciation for buildings was required. S. Rep. No. 97-144, 1981-2 C.B. at 428; H.R. Conf. Rep. No. 97-215 (1981), 1981-2 C.B. 481, 488.

In its explanation of ACRS relating to gain on disposition and recapture of depreciable property subject to ACRS, the Joint Committee on Taxation Staff stated that "Congress did not intend a retirement of a structural component of the building to be a disposition requiring recognition of gain or loss. Thus, if the roof wears out, no loss is recognized upon retirement and the unadjusted basis of the building is not reduced (i.e., cost recovery continues over the remaining recovery period). If the roof is replaced, the unadjusted basis of the new roof is recovered over a new recovery period beginning in the month it is placed in service." Joint Committee on Taxation Staff, General Explanation of the Economic Recovery Act of 1981, 97th Congress, 1st Session (1981), (the “Blue Book”).

In 1984, IRS and Treasury issued proposed regulations under ACRS. Prop. Reg. § 1.168-2(l)(1) defines “disposition” and Prop. Reg. § 1.168-6 provides rules for recognizing gain or loss upon the disposition of ACRS property. Consistent with the Blue Book, Prop. Reg. § 1.168-2(l)(1) provides that a disposition does not include the retirement of a structural component of a building and, Prop. Reg. § 1.168-6(b) provides that no loss shall be recognized upon the retirement of a structural component. Prop. Reg. § 1.168-6(b) illustrates this rule by using the roof-replacement example contained in the Blue Book.

The Tax Reform Act of 1986 (the 1986 Act) replaced ACRS with the Modified Accelerated Cost Recovery System (MACRS) for determining depreciation for tangible property placed in service after 1986. The legislative history to MACRS (§ 168) clearly prohibits the use of component depreciation. S. Rep. 99-313, 2nd Session, 1986-3 (Vol. 3) C.B. 1, 105. Accordingly, a taxpayer must continue to use the same recovery period and depreciation method, which are prescribed by MACRS, for a building and all of its structural components.

A disposition of MACRS or ACRS property generally does not include a retirement of a structural component of a building. See Treas. Reg. § 1.168(i)-1(e)(1) (definition of disposition for MACRS assets included in a general asset account). Thus, a taxpayer generally may not recognize a loss upon the retirement of a structural component until the entire building is disposed of. As a result, when a taxpayer replaces a structural component of a building, the taxpayer cannot recover the costs allocable to the removed component, but must continue to depreciate these costs. If a taxpayer is also required under § 263 to capitalize the costs of the replacement component, then the taxpayer is depreciating both components, each over a 27.5 or 39-year recovery period, even though one component has been retired.

Dispositions of Leased Property

Section 168(i)(8)(B), allows a lessor to recognize gain or loss upon the disposition of certain leasehold improvements at the termination of the lease instead of when the entire building is disposed of. For purposes of determining gain or loss, § 168(i)(8)(B) provides that an improvement that (a) is made by the lessor of leased property for the lessee of the leased property, and (b) is irrevocably disposed of or abandoned by the lessor at the termination of the lease by the lessee is treated as disposed of by the lessor when so disposed of or abandoned. The legislative history to § 168(i)(8)(B) provides that a similar result occurs for the lessee-owner of a structural component that is not retained by the lessee-owner upon termination of the lease. H.R. Conf. Rep. No. 104-737, 2nd Sess. (1996), 1996-3 C.B. 741, 937-38.

Dispositions of Assets Accounted for in Mass or General Asset Accounts

Under ACRS rules, taxpayers were permitted to elect to account for mass assets, in one account. These accounts, called “mass asset accounts” contain only mass assets with the same class life and the same placed-in-service year. See Prop. Reg. § 1.168-2(h). MACRS allows a very similar election to account for assets in one account. These accounts, called “general asset accounts” are not limited to mass assets. They contain assets that have the same asset class, depreciation method, recovery period, convention, and placed-in-service year. While the terminology is different, the treatment for these asset accounts is very similar. See Treas. Reg. § 1.168(i)-1.

For purposes of determining gain upon disposition, assets belonging to either a mass or general asset account are to be treated as having an adjusted basis of zero. Therefore, no loss is realized and generally any amount realized is recognized generally as ordinary income. If an asset in a mass or general asset account is disposed of by transfer to a supplies or scrap account, the asset in that account will also be assigned a zero basis.

When a disposition from a mass or general asset account is made, generally the unadjusted basis and depreciation reserve of the account are not affected by the asset(s) disposed of. The disposed asset(s) remains in the account. Depreciation of that asset account continues resulting in a delay in basis recovery for the asset(s) disposed of.

The assets in any particular general asset account are depreciated as a single asset. See T.D. 8566, 1994-2 C.B. 20. Assets in a particular mass asset account are similarly depreciated. As a result, for depreciation and disposition purposes, a particular mass or general asset account is the asset or UOP. New Appendix sections 6.24 and 6.25 of Rev. Proc. 2008-52 are not available to taxpayers who want to change the UOP used in determining when the taxpayer has disposed of assets in a mass or general asset account.

Adjusted depreciable basis can be a concern for taxpayers electing mass or general asset accounts who later want to re-define their UOP from smaller units to larger units for purposes of § 263(a). In these cases, basis will need to be determined based on the taxpayer's records. Under § 263(a), mass or general asset accounts are not to be considered a UOP.

In addition to mass and general asset accounts, taxpayers may account for pre-ACRS assets by means of group, classified and composite accounts. Treas. Reg. § 1.167(a)-7 requires permanent records be maintained to reconcile book to tax differences and for the determination of basis.

For questions regarding Dispositions please contact the Capitalization Technical Advisors.

APPENDIX E: RELATED ISSUES

For a taxpayer changing their method of accounting to re-characterize previously capitalized costs under § 263(a) as deductible repairs and maintenance under § 162, an § 481(a) adjustment is required in the year of change in order to prevent amounts from being duplicated or omitted. A capital to repair change in accounting method will generally result in a negative § 481(a) adjustment, which is primarily due to a change in the adjusted basis of property.

There are a number of Code sections for which a change in the adjusted basis of property may impact the proper application of that Code section, or conversely, another Code section can impact the proper adjusted basis in a tangible asset. This appendix is intended to alert the reader to the most prevalent areas of concern.

A careful review of the mechanics of the § 481(a) adjustment is necessary in order to evaluate the accuracy of the calculation. The following paragraphs are presented to alert the reader to some of the most likely basis change implications. This appendix is not intended to cover all possible areas impacted and the reader should consider other issues based on the facts and circumstances in each case.

Sections §§ 110, 118(a) and 362(c) Basis Considerations

Some taxpayers receive incentives from developers and/or lessor to reimburse them for the cost of constructing a new facility (e.g., retail store) or remodeling/ updating an existing facility (e.g. restaurant). Taxpayers usually receive these incentives in the form of a cash payment. In these situations, a taxpayer may exclude these amounts from gross income under §§ 110 or 118 where the taxpayer meets the requirements of either provision. A taxpayer applying § 118 to such incentives, is required to reduce the basis of the acquired properties. A taxpayer/lessee applying § 110 is not treated as having a depreciable interest in the acquired properties to the extent of the amount of the incentives and, therefore, must reduce the basis of the acquired properties.

The basis reduction method will vary by taxpayer and by transaction depending on the cost of the acquired property and the incentive amount received by the taxpayer. The taxpayer's Fixed Asset and/or Depreciation Schedules may disclose the reduction of basis for a specific asset or assets or it may include a separate negative asset (contra account), which effectively reduces the basis of each asset within the asset category for the facility. In some cases this contra account has not been considered when the § 481(a) adjustment for the change in accounting method for previously capitalized assets is computed. Examiners should be alert to this potential issue when properties are subject to lease agreements.

If you encounter a situation in which a taxpayer reclassifies incentives previously classified as costs associated with tangible capital expenditures under § 263(a) you should contact the § 118 Technical Advisor or the Retail Technical Advisors for assistance.

Sections §§ 168 and 179 Special Depreciation Rules

The basis of assets subject to special depreciation rules must be considered. Examiners should ensure that the tax basis used in computing the § 481(a) calculation is net of related adjustments allowed under § 168(k) additional first year depreciation; § 179 election to expense depreciable assets; and § 168(e)(3)(E) qualified retail improvement property, qualified restaurant property, or qualified leasehold improvement property. The following example illustrates the primary considerations under this heading.

In 2004, X Corporation purchased and placed in service new window blinds to cover windows in their retail store. The total cost of all blinds purchased and placed in service in 2004 was $5,000. The taxpayer identified the blinds as included in Asset Class 57.0 of Rev. Proc. 87-56, § 1245 assets used in a retail business, with a MACRS GDS recovery period of 5 years. X Corporation claimed a bonus depreciation deduction in 2004 at a 50% rate under § 168(k) resulting in a deduction in the amount of $2,500. In addition, in 2004, X Corporation began to depreciate the blinds utilizing the noted MACRS GDS with a 5-year recovery period and the half-year convention. The following table reflects the bonus depreciation deduction and yearly depreciation deductions through tax year 2006.

		2004		Depreciation		
Property Description	Cost	Bonus Depreciation	Depreciable Basis	2004	2005	2006
Window Blinds	$5,000	$2,500	$2,500	$500	$800	$480

X Corporation filed a Form 3115 for tax year 2007 to change the treatment of the cost of the blinds from capital under § 263(a) to repair under § 162. Their negative § 481(a) adjustment in the year of change is $720, which is computed as follows:

Cost	$5,000
Less: Bonus Depreciation	2,500
Less: Accumulated Depreciation	1,780
Negative 481(a) Adjustment	720

Separate from exam inquiries into the propriety of the capital to repair change for the cost of the window blinds, the example highlights additional items that warrant attention. Since the analysis of the § 481(a) adjustment is typically presented in work papers specifically associated with the repair analysis, it is important to ensure that the asset basis is correctly determined. First, it is necessary to ensure that if bonus depreciation was previously claimed for an item included on the Form 3115 that the amount of the bonus depreciation is properly factored into the computation of the § 481(a) adjustment. Second, it is necessary to ensure that the actual amount of depreciation previously claimed is properly accounted for in the computation of the § 481(a) adjustment. A complicating factor in performing these tasks is that taxpayers often consolidate this analysis by grouping assets according to recovery periods, which requires confirmation that the assets have been properly segregated.

Similarly, adjustments to asset basis for purposes of computing § 179 election to expense depreciable assets, and § 168(e)(e)(E) qualified retail improvement property, qualified restaurant property, or qualified leasehold improvement property should also be traced.

Section § 199 Qualified Production Activities Income (QPAI) Calculation and the Impact of § 481(a) Adjustments to Domestic Production Gross Receipts (DPGR)

Change in Accounting Method § 481(a) adjustments should be included in the calculation of QPAI under the final Treas. Reg. § 1.199.

Treas. Reg. §1.199-8(g) states that for purposes of determining QPAI, a § 481(a) adjustment, whether positive or negative, taken into account by a taxpayer during the taxable year that is solely attributable to either the taxpayer's gross receipts, cost of goods sold (CGS), or deductions must be allocated or apportioned between DPGR and non-DPGR using the methods used by a taxpayer to allocate or apportion gross receipts, CGS, and deductions between DPGR and non-DPGR for the current taxable year.

Under § 199(a), the § 199 deduction is determined by applying a percentage to the lesser of the taxpayer's QPAI or taxable income (determined without regard to the §199 deduction). The applicable percentage is 3% for taxable years beginning in 2005 and 2006, 6% for taxable years beginning in 2007 through 2009, and 9% for taxable years beginning after 2009.

Under § 199(c)(1), QPAI is determined by taking DPGR for the taxable year less CGS allocable to such DPGR, less other expenses, losses, or deductions, which are properly allocable to such DPGR. Section 199(c)(4)(A)(i) provides that DPGR means the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of (1) qualifying production property ("QPP"), which was manufactured, produced, grown or extracted by the taxpayer in whole or significant part within the U.S.; (2) any qualifying film produced by the taxpayer; or (3) electricity, natural gas, or potable water produced by the taxpayer in the United States. Section 199(c)(5) provides that QPP includes tangible personal property, any computer software, and any property described in Treas. Reg. § 1.168(f)(4) (qualified sound recordings).

Under §§ 199(c)(4)(A)(ii) and (iii), DPGR also includes gross receipts of the taxpayer derived from construction of real property by the taxpayer in the United States if the taxpayer is engaged in the active conduct of a construction trade or business; and engineering or architectural services performed by the taxpayer in the United States in the ordinary course of its trade or business with respect to the construction of real property in the United States if it actively conducts an engineering or architectural services trade or business.

In determining its QPAI, a taxpayer must subtract from its DPGR, in addition to its CGS allocable to DPGR, the deductions that are properly allocable to DPGR. A taxpayer generally must allocate and apportion these deductions using the rules of the § 861 method. In lieu of the § 861 method, certain taxpayers may apportion these deductions using either the simplified deduction method or a small business simplified overall method that may be used by a qualifying small taxpayer. A taxpayer using the simplified deduction method or the small business simplified overall method must use that method for all deductions. A taxpayer eligible to use the small business simplified method, may choose at any time for any taxable year to use the small business simplified overall method, the simplified deduction method, or the § 861 method for a taxable year. A taxpayer eligible to use the simplified deduction method may choose at any time for any taxable year to use the simplified deduction method or the § 861 method for a taxable year.

Treas. Reg. § 1.199-8(g) addresses § 481(a) adjustments. For purposes of determining QPAI, an § 481(a) adjustment, whether positive or negative, taken into account by a taxpayer during the taxable year that is solely attributable to either the taxpayer's gross receipts, CGS, or deductions must be allocated or apportioned between DPGR and non-DPGR using the methods used by a taxpayer to allocate or apportion gross receipts, CGS, and deductions between DPGR and non-DPGR for the current taxable year. See Treas. Reg. §§ 1.199-1 and 1.199-4 for rules related to the allocation and apportionment of gross receipts, CGS, and deductions, respectively.

If an § 481(a) adjustment is spread over more than one taxable year, then a taxpayer must attribute the § 481(a) adjustment among gross receipts, CGS, or deductions, as applicable, in the same amount for each taxable year within the spread period. For example, if a taxpayer, using a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, determines that an § 481(a) adjustment that is required to be spread over four taxable years should be attributed half to gross receipts and half to deductions, then the taxpayer must attribute the § 481(a) adjustment half to gross receipts and half to deductions in each of the four taxable years of the spread period. Further, if such taxpayer uses the simplified deduction method to apportion deductions between DPGR and non-DPGR in the first taxable year of the spread period, then the taxpayer must use the simplified deduction method to apportion half the § 481(a) adjustment for that taxable year between DPGR and non-DPGR for that taxable year. Similarly, if in the second taxable year of the spread period the taxpayer uses the § 861 method to apportion and allocate costs between DPGR and non-DPGR, then the taxpayer must use the § 861 method to allocate and apportion half the § 481(a) adjustment for that taxable year between DPGR and non-DPGR for that taxable year. Treas. Reg. § 1.199-8(h) addresses disallowed losses or deductions, and provides, in part, except as provided by publication in the Internal Revenue Bulletin, that losses or deductions of a taxpayer that otherwise would be taken into account in computing the taxpayer's § 199 deduction are taken into account only if and to the extent the deductions are not disallowed by §§ 465 or 469, or any other provision of the Code.

The § 481(a) adjustment (per the taxpayer) equals the difference in (1) adjusted basis attributable to erroneously capitalized repairs and maintenance as of the end of the taxable year immediately preceding the taxable year of change under the applicant's present method of accounting, and (2) adjusted basis attributable to such amounts as of the end of the taxable year immediately preceding the taxable year of change under the applicant's proposed method of accounting (i.e., zero).

It appears that many of the costs included in the accounting method change relate to plant or manufacturing costs or those associated with the qualified production activities. Further, regardless of whether these repairs are reflected as part of CGS or as an "other deduction" by the taxpayer, the result is the same. As such, the § 481(a) adjustment that results from the accounting method change that relates to the qualifying activity should be included in QPAI.

For further information regarding the impact of the § 481(a) adjustments on the § 199 calculation, please contact the §199 Technical Advisors.

§ 263A Self Constructed Assets and Construction Period Interest

Section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business. Taxpayers subject to § 263A must capitalize all direct costs and certain indirect costs properly allocable to real and tangible personal property produced. Treas. Reg. § 1.263A-1(e)(3)(i) provides that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of the production activities. Thus, § 263A applies to the production of self-constructed assets, including assets produced for the taxpayer under a contract. See Treas. Reg. §§ 1.263A-1(a)(3)(ii), 1.263A-1(d)(1) and1.263A-2(a)(1)(ii)(B). For example, § 263A requires the capitalization of the costs of a new branch built by a bank or a new addition to an office building built by a manufacturing company.

A significant number of taxpayers that are filing Form 3115 for capitalization to repair changes are "producers" for purposes of § 263A and are required by this Code section to capitalize construction projects completed in prior years subject to the rules of § 263A. For these taxpayers, many of the costs subject to a change from capital to repair treatment are indirect costs properly allocable to property produced or property acquired for resale.

Expenditures for property subject to both §§ 263(a) and 263A are required to be capitalized under § 263A. See Treas. Reg. § 1.263(a)-1(b). To the extent that these costs are deducted in the year(s) under examination, the examiner should ensure that the correct amount is properly allocated to the taxpayer's eligible property remaining on hand at the close of the taxable year(s). The examiner should secure copies of the taxpayer's § 263A calculations for each period under examination in order to perform this review.

Treas. Reg. § 1.263A-8(a)(1) provides that capitalization of interest under the avoided cost method described in

Treas. Reg. §1.263A-9 is required with respect to the production of designated property. For this purpose, Treas. Reg. § 1.263A-8(b)(1) defines designated property as any property that is produced and that is either real property or tangible personal property (as defined in Treas. Reg. § 1.263A-2(a)(2)) which meets any of the following criteria:

(A) Property with a class life of 20 years of more under § 168 (long-lived property), but only if the property is not property described in § 1221(l) in the hands of the taxpayer or a related person,

(B) Property with an estimated production period (as defined in Treas. Reg. § 1.263A-12) exceeding 2 years (2-year property), or

(C) Property with an estimated production period exceeding 1 year and an estimated cost of production exceeding $1,000,000 (1-year property).

The thresholds described above are applied separately for each UOP as defined in Treas. Reg. § 1.263A-10. The UOP as defined in Treas. Reg. § 1.263A-10 is used as the basis in determining accumulated production expenditures under each Treas. Reg. § 1.263A-11 and the beginning and end of the production period under Treas. Reg. § 1.263A-12. Whether property is 1-year or 2-year property under Treas. Reg. § 1.263A-8(b)(1)(ii) is also determined separately with respect to each UOP as defined in Treas. Reg. § 1.263A-10.

Treas. Reg. 1.263A-10 provides that a UOP includes any components of real property owned by the taxpayer or a related person that are functionally interdependent. Components of real property produced by, or for, the taxpayer, for use by the taxpayer or a related person are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person.

A significant number of the Form 3115 capital to repair changes result from a CAM defining the applicable UOP. Specifically, the change from capital to repair treatment is often the result of utilizing a more expansive UOP. Although the definition of UOP in Treas. Reg. § 1.263A-10 is for determinations under Treas. Reg. §§ 1.263A-8, 1.263A-11, and 1.263A-12, examiners should evaluate whether the use of a larger UOP for purposes of the Form 3115 capital to repair changes results in required changes with respect to interest capitalization under § 263A(f). To the extent that the Form 3115 includes changes to costs associated with the production of designated property (as defined under §1.263A-8), examiners should determine whether the § 481(a) adjustment includes an adjustment for interest capitalization under § 263A(f) and if not, whether such an adjustment is required under the taxpayer's new method of accounting.

For further information regarding the impact of § 263A adjustments on the § 481(a) calculation, please contact either of the §263A Technical Advisors or Capitalization Technical Advisors.

APPENDIX F

Computer Audit Specialist Support

The use of a statistically valid sample is encouraged. This applies both to samples initiated by the taxpayer as well as those initiated by the Service.

On January 15, 2010, the Service published an updated policy and procedure statement issued by the statistical sampling program, Policy Number 003. This policy statement covers two methods for allocating projected statistical sampling results to known population categories. The relative reported amount method and the relative point estimate of the difference estimator method are each discussed. These methods are recommended for allocating adjustments.

This policy statement also describes the preferred method for computing associated adjustments; for example adjustments to depreciation when changes are made to items previously capitalized. For these types of adjustments, the policy and procedure statement suggests the relative point estimate of the difference estimator method be used.

For further information and assistance on these statistical sampling questions, please contact a National Statistical Sampling Coordinator.