

# New IRS Repair Regulations Require Special Attention Now

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## Frequently Asked Questions



### **Why are the new repair regulations important?**

On September 13, 2013, the Internal Revenue Service (IRS) released final regulations addressing the treatment of repairs and maintenance expenses for federal income tax purposes. The new regulations affect all taxpayers with tangible property. They go way beyond just repairs and change the treatment of repairs and maintenance, materials and supplies, spare parts, and acquisition costs. The rules represent a significant change for most taxpayers. The new rules are highly subject, extremely complex and include numerous traps for unsophisticated taxpayers. Undoubtedly, the new rules will increase your annual reporting burden.

### **Is my business required to comply with the regulations?**

Yes. Compliance with the new regulations is mandatory for tax years beginning on or after January 1, 2014. Failure to comply with the new regulations can result in the assessment of additional tax, interest, and penalties at both a federal and state level.

### **What aspects of my business are impacted by the new regulations?**

The new regulations impact the manner in which your business treats repair and maintenance expenditures for income tax purposes. Items that you have expensed in the past may now be required to be capitalized, and vice versa.

However, the impact of the regulations is more far-reaching. They could also change the income tax treatment of materials and supplies, rotatable spare parts, acquisition costs, and the

accounting for items that you are deemed to dispose when you make significant repairs.

### **Why do I need to involve my accountant in the process?**

The new regulations are extremely complex as illustrated by just a few examples below. In general, these changes make it more likely that your business will be required to capitalize rather than expense certain repair and maintenance costs.

- The definition of a “unit of property” is changed and requires that certain structural components of a building be treated as a separate “building system”; rather than allowing an entire building to be treated as a single unit of property.
- The regulations also define a “unit of property” in terms of equipment that your business utilizes.
- Any expenditure that meets the definition of a betterment, restoration, or adaption generally must be capitalized. The interpretation of these terms can be very subjective – despite the numerous examples provided for clarification.

### **Why should I be concerned about the new regulations now?**

The regulations are retroactive. The IRS has the ability to look to your expenditures in previous years to determine if any of those items should have been capitalized rather than expensed. On audit, these expenditures can be capitalized in the earliest open year.

The IRS will treat adjustments of this type as a change in accounting method, allowing them to add these adjustments to taxable income.

Businesses that identify these expenditures now, can file for a protective change in accounting method. There are three benefits of taxpayer-initiated changes in accounting methods. First, if you make the required change voluntarily, you are allowed to spread any additions to income over four years rather than one (any reduction in income is taken into account in the year of change). Second, when the change is initiated by the IRS, the change is made to the earliest open year (generally, the third preceding year) and the IRS imposes interest and penalties. Third, if the IRS makes the change, you can be certain it will make the change in a manner in which the tax due is maximized; however, if you make the change, you can carefully plan and minimize the additional income you must pick up (or maximize any additional deductions).

There are other reasons to act now. Understanding now how the new rules will impact the accounting for repairs, materials and supplies, and spare parts (and implementing changes to comply) will likely save significant time at year-end for your accounting staff by reducing the amount of analysis that must be done when they are at their busiest. Proactive compliance ensures better tax planning and enables your organization to determine which accounting method changes are necessary and which tax elections are most beneficial to your organization.

### **What must I do to comply with the regulations?**

The IRS has indicated verbally, that they anticipate most business taxpayers will need to file Form 3115 (Change in Accounting Method) to comply with the regulations. Completing this filing will generally require at least some analysis of the expenditures for repairs and maintenance, materials and supplies, and rotatable spare parts to determine what accounting methods must be changed (yes, there may be more than one) and what the dollar impact of those changes might be.

The regulations also outline a number of tax and safe harbor elections that can be made

including: routine maintenance safe harbor, de minimis expensing, small taxpayer safe harbor, incidental materials and supplies, and capitalizing repair and maintenance costs. Implementing required policy changes and ensuring consistency with financial reporting should be done sooner rather than later.

### **What opportunities are available to my business as a result of the regulations?**

Most taxpayers will not look favorably on the changes. However, there may be opportunities to implement changes that are favorable. For instance, when significant building components are replaced (a roof for example), an opportunity may arise to deduct the remaining basis on the existing roof.

The IRS has verbally indicated that 2014 will be the only year in which they will allow accounting method changes to recoup the remaining basis of any "partial disposals" that occurred prior to 2014. In subsequent years, claiming a partial disposition deduction will be done via an annual election.

For small business taxpayers, the regulations incorporated a safe harbor provision. Under the small business safe harbor, a qualifying taxpayer for the three prior tax years must have *average* gross receipts of less than or equal to \$10 million. Under the safe harbor, a small taxpayer is not required to capitalize improvements if the total amount paid for repairs, maintenance, and improvements during the year does NOT exceed the lesser of \$10,000 or 2% of the unadjusted (equal to cost) basis of the building. Only buildings with an unadjusted basis of \$1 million or less qualify for this safe harbor.

Other opportunities include the ability to adopt a method that permits the expensing of certain de minimis purchases including computers, chairs, small printers, and other items that satisfy certain dollar limitations. A new routine maintenance safe harbor rule applies to both buildings and equipment provided the maintenance is performed at certain intervals.

**Does book treatment need to be the same as the tax treatment for repairs made to building structures?**

Taxpayers are not required to use the same method for determining improvement versus repair costs for book and tax purposes.

**Does the cost of a new roof of \$10,000 have to be capitalized?**

The answer depends how much of the roof is being replaced and whether it is repaired with the same or comparable parts versus improved parts that could result in a material addition or increase in capacity of the building structure or reasonably expected to increase the productivity, efficiency, strength, quality, or output of the building structure. Additionally, it should be determined whether the replacement of the roof should be treated as the replacement of a major component or a large component of the building structure.

For example, the IRS regulations provide that you generally do not have to capitalize the

cost of replacing a roof membrane, but you do have to capitalize the costs of replacing the entire roof. Generally under the old rules, roof replacements constituted deductible repairs.

**If my HVAC breaks down and needs to be repaired, do I have to capitalize the costs?**

The answer depends on whether or not the activity undertaken with respect to the HVAC results in an improvement to the building unit of property under the improvement rules. The improvement analysis must be done on a building system by building system basis. Under the regulations, all HVAC units are considered ONE building system. Thus, you will need to determine whether the activity undertaken results in a betterment, restoration, or adaption of ALL of the HVACs in the building.

For example, the IRS regulations provide that you generally do not have to capitalize the cost of replacing three of 10 roof-mounted heating and air conditioning units, but you do have to capitalize the replacement of a sole chiller unit.

## Can you give me some additional examples of what I can deduct and what I must capitalize?

The new regulations include 152 examples in total, many of which are highly subjective and complex. Here are some of the distinctions the new regulations make:

Generally Allowed to Expense	Generally Must Capitalize
Replacing asbestos insulation with similar nonasbestos insulation	Remediating soil contaminated by previous owner
Performing minor repairs and maintenance shortly after purchase	Bringing a residential building up to higher standards
Performing a retail refresh limited to cosmetic layout changes	Performing a retail refresh along with increasing storage and adding a loading dock
Painting walls and filling in holes	Painting walls and filling in holes if done when performing a major remodel
Relocating cash registers	Relocating machines for increased capacity
Replacing a roof membrane	Replacing an entire roof
Removing a drop ceiling	Repairing storm damage for which insurance proceeds were received
Replacing two of 10 HVAC units that are 10% more efficient	Replacing a single chiller in HVAC system
Replacing power switch	Adding restaurant drive-through
Replacing one of three furnaces in HVAC system	Replacing all toilets and sinks with new toilets and sinks of the same quality
Replacing 30% of an electrical system	Replacing the entire electrical system
Replacing eight of 20 sinks	Replacing a sprinkler system
Replacing 100 of 300 exterior windows comprising 8.3% of surface area	Replacing 200 of 300 exterior windows
Replacing lobby floors comprising 10% of square footage	Replacing 100 of 300 exterior windows comprising 30% of surface area
Replacing one of four elevators	Replacing floors in all public areas comprising 40% of square footage
	Replacing one of four elevators, but claim a loss on partial disposition

As you can see from these examples, the determination of what you can and cannot treat as a deductible repair is not based on any bright line tests. Instead, the determination is made based on a number of highly subjective factors such as whether the expenditure materially increases the productivity, efficiency, strength, quality, or output of the unit of property. Another subjective standard included

in the new regulations provides that you must capitalize expenditures incurred to replace a major component or a substantial structural part of a unit of property. Even the definition of unit of property is now subjective with a series of different rules applying in the case of buildings, leased property, plant property, condominiums, coops, and network assets.

## What steps should I be taking?

Proactive compliance with the regulations is critical. Wipfli is available to help you analyze and address these important new regulations in the light of your business situation. Here are some of the things you should be considering:

1. What are your current accounting policies? Do they need to be updated and modified?
2. Have you recently filed Form 3115 for a change in accounting method related to repairs and maintenance? It should be reviewed in light of the new regulations. Does the accounting method need to be changed? If favorable adjustment to taxable income resulted with the original filings, do these adjustment need to be recaptured under the new regulations?
3. Have you implemented a de minimis expense policy? Should one be put in place immediately?
4. Have you engaged in significant repair/remodel projects? Does the opportunity exist to deduct partial dispositions?
5. Are you purchasing new real estate? Consideration should be given to segregation of building systems in light of the regulations.
6. How do your past practices for expensing repair and maintenance costs stack up when considering the definitions of “unit of property”, betterment, restoration and adaptation? Will a change in accounting method be required to comply with the regulations?
7. What training will be necessary for your accounting staff to ensure compliance with the regulations? Steps should be taken to ensure that your staff has a working knowledge of the basics.

## About Wipfli LLP

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