



## IRS Releases Final Repair Regulations for Property Expenditures

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An undeclared battle has been waging for years between the IRS and many Los Angeles and Southern California businesses that own or lease tangible property regarding whether expenditures related to such property should be expensed or capitalized. Expensed property can be deducted immediately as a current expense, but capitalized property must be depreciated and deducted over a period of up to 39 years. Therefore, expensing is usually preferable to capitalization.

Businesses have been waiting for almost a decade for the IRS to issue final regulations to clarify the uncertainty surrounding the tax treatment of expenses related to tangible property. The first set of proposed IRS regulations was released in 2006, followed by another set in 2008 and finally, the release of temporary regulations in 2011. But it wasn't until last month that the IRS finally released final regulations: IRS T.D. 9636, also referred to simply as the "Repair Regs."

### Capitalization vs. Expensing

The Repair Regs, which apply to tax years beginning on or after January 1, 2014, provide guidance to help businesses comply with Internal Revenue Code Sections 162 and 263, which detail IRS guidelines regarding capitalization and expensing of expenditures related to tangible property. These sections require capitalization of expenses allocated to acquiring, producing and improving tangible property, but allow expensing of money spent on incidental repairs and maintenance of tangible property.

So how do you distinguish between these different kinds of expenses? Fortunately, the Repair Regs include a safe harbor that covers routine property maintenance (including buildings). Recurring activities dedicated to using property and keeping it in efficient operating condition (such as inspection, cleaning and testing, and replacement of worn or damaged parts) can be expensed and immediately deducted. Routine activities are those that your business reasonably expects to perform more than once during the property's class life. For commercial buildings, this is defined as more than once every 10 years.

Materials and supplies (non-inventory) used in the course of performing routine property maintenance can be expensed and deducted if they meet specific criteria. For one, they must be acquired to maintain, repair or improve a unit of tangible property. Fuel, lubricants, water or similar items reasonably expected to be consumed in 12 months or less qualify for expensing, as do units of property with a useful life of no more than 12 months and an acquisition or production cost of no more than \$200.

The timing of these deductions depends on the specific type of materials and supplies used. Incidental supplies (like office and cleaning supplies) can be deducted when they are purchased, but non-incidentals (like small engine parts, fuel and motor oil) can't be deducted until they are first used. Rotable, temporary and standby emergency spare parts are deductible when they are disposed of. Or, you can treat these as depreciable assets and capitalize them.

## **Improvements vs. Repairs**

The Repair Regs require a distinction between improvements and repairs in order to determine whether expenses related to commercial buildings can be expensed and deducted or must be capitalized and depreciated. Making this distinction requires understanding the concept of units of property, or UOPs, because the Repair Regs changed the application of UOPs.

A commercial building's UOP is defined as the building (e.g., the walls, roof, foundation, windows and doors) and all of its structural components together (structural components typically include things like HVAC, plumbing and electrical systems, elevators and escalators, and security systems). Work performed on a building must be capitalized if the level of improvement results in a betterment, restoration or adaption when applied to the building and its structural components together. However, the Repair Regs change how improvement standards are applied to the building and its structural components: You must now consider the effect of expenses on specifically defined components, not on the building and its components together.

For example, consider a commercial building with an HVAC system that includes five different roof-mounted units. The units are not connected and have separate duct work and controls. If repair and maintenance work were performed on the HVAC system, would the costs be capitalized or expensed?

The building and all of its structural components (including the HVAC system) are considered to be a single unit of property, while the HVAC system itself (including the roof-mounted units and their components) is considered to be a building system. Therefore, expenses related to repairing and maintaining the units must be capitalized if the work results in a betterment, restoration or adaption of the HVAC system and/or the building.

A safe harbor in the Repair Regs applies to small businesses with sales up to \$10 million. These businesses can expense and deduct (rather than capitalize) repair, maintenance, improvement and similar expenses if the building's initial cost is no more than \$1 million and the total amount of these expenses for the tax year are no more than \$10,000 or 2% of the building's adjusted basis, whichever is less.

## **Concluding Thoughts**

After nearly a decade, the IRS has finally released final regulations providing guidance to help businesses comply with IRC Sections 162 and 263, which detail IRS guidelines regarding capitalization and expensing of expenditures related to tangible property. These sections require capitalization of expenses allocated to acquiring, producing and improving tangible property, but allow expensing of money spent on incidental repairs and maintenance of tangible property. The Repair Regs are extensive and detailed — an outsourced CFO services provider can help if you need further guidance on how they impact your business.

## **About CFO Edge**

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