PUBLICATION

IRS Releases New Regulations Governing Repair Expenditures

January 30, 2012

Last month, the Internal Revenue Service (IRS) released long-awaited regulations governing the tax treatment of expenditures incurred to repair tangible property (New Regulations). These New Regulations attempt to clarify and expand upon the current regulations that exist under Sections 263(a) and 162(a) of the Internal Revenue Code (Code), and also attempt to address issues associated with property subject to Code Section 168.

Though the New Regulations are in temporary and in proposed form, they do have the potential to affect any taxpayer that owns, produces or repairs tangible property. Some industries that could be affected more than others include energy producers, utilities, telecommunication companies, aviation companies and real estate concerns, as well as many other capital intensive businesses. Despite the New Regulations being issued in temporary form, taxpayers are required to comply -- though there will be a period for comment, and likely official guidance, before the New Regulations become final.

Background

The New Regulations have been an ongoing project within the Treasury Department for nearly a decade. The distinction between currently deductible expenses and expenditures that must be capitalized has generally been an analysis driven by the facts and circumstances of a taxpayer's particular situation. A taxpayer can generally deduct the full cost of a repair in the year that the expense is incurred; however, improvements constituting more than just repair generally must be capitalized over a fixed life. Thus, the distinction over what constitutes a repair as compared to an improvement, as well as what piece of property was improved, led to much confusion and litigation.

The IRS endeavored to simplify the process by releasing several hundred pages of proposed regulations in 2006, which were later withdrawn, as well as another set released in 2008. The New Regulations just released by the IRS retain many of the provisions of the 2008 draft, which incorporated much of the already existing authority that had been promulgated under the relevant Code sections; however, there are some significant changes in the New Regulations as well.

Some Significant Changes

One significant change in the New Regulations is the application of the aforementioned improvement or repair standards to buildings. The expenditure in question for a building must be looked at for its effect on major components or systems of the building as opposed to the building as a whole. Thus, the taxpayer must determine whether a repair or improvement was made to the elevator system, the HVAC system or the plumbing system instead of determining whether a repair or improvement was made to the building generally.

The New Regulations also now allow taxpayers the ability to take a retirement loss for major building components such as those discussed above. Although the cost of a new component will have to be capitalized, the fiscal blow is somewhat softened by the fact that, under the New Regulations, the taxpayer may take a loss equal to the amount of basis allocated to the retired property that is being replaced.

What the New Regulations Mean for Taxpayers

The preamble to the New Regulations states that they "are generally effective for amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012," despite the fact that they are only in temporary form. Although taxpayers may not see the effect of these New Regulations on taxable income until their returns are filed, proper accounting procedures should be put in to place as soon as possible to ensure that the returns conform to the New Regulations. Additionally, taxpayers must consider the fact that in many cases the implementation of the New Regulations could require a Section 481 change in accounting method since the IRS is not allowing the New Regulations to apply to the 2011 tax year.

The changes briefly discussed above are just a few of several changes that are included in the 255 pages comprising the New Regulations. To discuss these changes in greater detail, please do not hesitate to contact any of the attorneys in the Firm's Tax Department.