

***CALIFORNIA CPA EDUCATION FOUNDATION***

**2011 Federal & California Tax Update  
for  
Businesses & Estates**

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**January 2012 Supplement**

## 2012 Busy Season Look-Out List

- **Foreign Asset Reporting:** New Form 8938 required for individuals with specified foreign financial asset holdings over threshold amounts.
- **Cost Basis Reporting:** New Form 8949 requires segregation and identification of capital gain transactions. (*Sch. D Instructions*)
- **Cost Basis Elections:** New cost basis rules require election of default methods for determining basis of stock and mutual funds.
- **Capitalization Regs:** Regulations effective 1/1/2012 provide new rules and safe harbors for distinguishing capital expenditures from repairs. (*Reg §1.263(a)-2T & 3T*)
- **Revised Schedule E:** Disclosure of property type required.
- **Form 1099-MISC Questions:** Business tax returns and 1040 Schedules C, E, and F require inquiry regarding client filing of Form 1009s.
- **Passive Activity Grouping Disclosure:** New passive activity grouping disclosure rules kick in for activities acquired in 2011. (*Rev. Proc. 2010-13*)
- **Late Aggregation Elections for Real Professionals:** Retroactive rental property aggregation election allowed for real estate professionals under the new relief provision. (*Rev. Proc. 2011-34*).
- **Mortgage Assistance Payments:** Safe harbor method for reporting mortgage interest and property tax payments for recipients of federal mortgage assistance payments. (*Notice 2011-14*)
- **Adult Child Insurance Coverage:** California retroactive conformity to 2010 federal law change creates potential refund opportunity for clients who reported a 2010 fed-Cal difference for health insurance on an adult child. (*AB 36*)
- **Self-Employed Health Insurance:** Health insurance premiums no longer deductible in computing SE Tax; however, IRS now allows Medicare premiums to count as SE health insurance.
- **Earned Income Tax Credit Due Diligence Requirements:** Submission of Form 8867 required to avoid \$500 preparer penalty.
- **Energy Credits:** New dollar limits and eligibility requirements apply in 2011 for residential energy credits and green vehicle credits. (*Secs. 25C, , 30, 30B, 30C*)
- **California Use Tax Table:** New standard use tax table for safe-harbor reporting of small internet purchases. (*SB 86*)

- **New Hire Credit:** Federal credit of \$1,000 for qualified employees hired in 2010 and retained for 52 weeks. (*Form 5884-B*)
- **Credit for Hiring Veterans.** Expanded work opportunity tax credit for hiring qualified veterans after 11/21/2011.
- **California Multi-State Apportionment Changes:** Single sales factor apportionment option (with market-based sourcing for services and intangibles) may be elected in 2011. “*Finnigan Rule*” applies for determining throwback sales of combined groups.
- **Bonus Depreciation Component Election:** Written election required to claim 100% bonus depreciation on components of building placed in service in 2011, where construction began prior to 9/9/2010. (*Rev. Proc. 2011-26*)
- **Accounting Method Changes:** New *Rev. Proc. 2011-14* replaced *Rev. Proc. 2008-52* as operative guidance for automatic accounting method changes. Includes a new automatic change for accrual of California franchise tax deduction.
- **IRS Voluntary Classification Settlement Program:** Low-cost settlement program offered by IRS to employers who have misclassified employees as independent contractors.
- **New California Penalties for Misclassifying Employees:** SB 459 gives the California Department of Industrial Relations authority to impose penalties on employers who misclassify employees as independent contractors. The penalty can also be imposed on CPAs who give incorrect advice on employee classification.
- **Innocent Spouse Relief:** IRS drops 2-year limit on filing claims for “equitable relief” under the innocent spouse rules. (*Notice 2011-70*)
- **Estate Tax \$5 Million Exclusion Portability:** For deaths of a first spouse in 2011, consideration must be given to filing a Form 706 in order to elect to carry over the unused exclusion amount to the estate of the surviving spouse.
- **Estate Tax Deductions for Unpaid Claims:** The IRS has established new procedures for filing protective claims for refund of estate tax based upon deductions for claims of against the estate that remain unpaid as of the filing date of the Form 706. (*Rev. Proc. 2011-48*)
- **Modified Carryover Basis Calculations:** IRS has established safe harbor rules for calculating the basis of assets inherited from the estate of a 2010 decedent that elects out of federal estate tax. (*Rev. Proc 2011-41*)
- **Reinstatement of Exempt Status:** IRS establishes procedures for charities to reinstate exempt status lost due to failure to file 990s. (*Notices 2011-43 & 44*)

## January 2012 Supplement

### Chapter 1:

#### **Insert after Page 1-4: P.L. 112-56 Extends and Expands WOTC for Veterans**

With the enactment of *The 3% Withholding Repeal and Jobs Creation Act* (P.L. 112-56 11/21/2011) Congress **repealed the 3% withholding requirement** that was scheduled to take effect in 2013 for all payments to government contractors providing property or services to a federal or state/local government agency.

In addition, the new law **extends and expands the Work Opportunity Tax Credit (WOTC)** applicable to “**qualified veterans**”. The general WOTC is scheduled to expire at the end of 2011. The new law extends the credit one year (i.e., through 2012) for qualified veterans and:

- expands the categories of veterans who are eligible for the credit
- increases the credit amount for certain veterans
- extends the credit to tax-exempt employers (by way of a payroll tax credit)
- provides for expedited procedures for certifying eligibility for the credit for veterans

Effective for employees who begin hired after Nov. 21, 2011, a *qualified veteran* is defined as:

- 1) A veteran who is a member of a family receiving assistance under a *food stamp program* under the Food Stamp Act of 1977 for at least 3 months, all or part of which are during the 12-month period ending on the hiring date.
- 2) A veteran who is entitled to compensation for a *service-connected disability*, and either:
  - a) is hired *within 1 year after having been discharged* or released from active duty in the U.S. Armed Forces, or
  - b) has aggregate periods of *unemployment* during the 1-year period ending on the hiring date of *at least 6 months*.
- 3) A veteran who has aggregate periods of *unemployment* during the 1-year period ending on the hiring date of at least *4 weeks*.

**Note:** The hiring credit is not limited to veterans of the Iraq and Afghanistan conflicts. The credit is available for hiring is any individual who served on **active duty** (other than for training) in the U.S. Armed Forces for **more than 180 days** (or who was released from active duty prior to 180 days due to a service-connected disability). Veterans must also not have served any of the active duty days during the 60-day period ending on the hiring date.

**Credit Amount:** The WOTC is calculated as **40%** of a specified amount of first-year wages, or **25%** for employees who have completed at least 120, but less than 400, hours of service for the employer. The specified amounts of first-year wages eligible for the credit are as follows:

- **\$6,000** for a veteran who qualifies under the food stamp rule or who was unemployed for 4 weeks in the year prior to hire (i.e, maximum credit of 40% x \$6,000 = \$2,400).

- **\$12,000** for a veteran with a *service-connected disability* who is hired within 1 year of being discharged from the military (i.e., maximum credit of 40% x \$12,000 = \$4,800).
- **\$24,000** for a veteran with a *service-connected disability* who has aggregate periods of at least 6 months of unemployment during the 1-year period ending on the hiring date (i.e., maximum credit of 40% x \$24,000 = \$9,600).
- **\$14,000** for a veteran who was unemployed for 6 months in the year prior to hire (i.e., maximum credit of 40% x \$14,000 = \$5,600).

**Tax-Exempt Employers:** The new law extends the WOTC to tax-exempt employers, allowing them to claim the credit for wages paid to a veteran hired after 11/21/2011. The credit is only allowed with respect to wages paid to a qualified veteran for services in furtherance of the activities related to the purposes or function constituting the basis of the organization's tax-exempt status.

The credit calculation for tax-exempt employers is as follows:

- The credit percentage of qualifying first-year wages is **26%** (instead of 40%).
- The credit percentage is **16.25%** (instead of 25%) for a qualified veteran who has completed at least 120, but less than 400, hours of service for the employer.
- The WOTC for qualified veterans is limited to the **employer portion of the social security tax** paid on the wages of all employees during the year following the veteran's hiring date.

**Fast-Track Certification of Unemployment:** Unlike the New Hire Credit (or the California New Jobs Credit) employees for whom a WOTC is claimed must be certified as qualifying for the credit at the time of hire. In California, the certification is done by the EDD. The new law provides that a veteran will be treated as certified as having the required aggregate periods of unemployment if he or she is certified by the local agency as having received unemployment compensation under State or Federal law for not less than 4 weeks or 6 months (as the case may be) during the 1-year period ending on the hiring date.

### **Page 1-8: Correction of 2012 Sec. 179 Expense Amounts**

For tax years beginning in 2012, the correct sec. 179 expense limit is **\$139,000**, with the phase-out of the limit for sec. 179 asset acquisitions in excess of **\$560,000**.

## **Chapter 2:**

### **Page 2-9: Form 8938 Finalized and Required for 2011 Tax Returns**

In conjunction with the publication of temporary regulations under sec. 6038D, governing the new foreign asset reporting rules, the IRS has issued the final version of Form 8938, *Statement of Specified Foreign Financial Assets*, which must be filed with Form 1040 for taxable years starting after March 18, 2010—i.e., 2011, for calendar year taxpayers. The final version of the form slightly lowers the asset values that will trigger the filing requirement.

The filing requirements for the new form are as follows:

#### **You must file Form 8938 if:**

##### **1) You are a “*specified individual*”, i.e.:**

- a U.S. citizen
- a resident alien of the United States for any part of the tax year
- a nonresident alien who makes an election to be treated as resident alien for purposes of filing a joint income tax return
- a nonresident alien who is a resident of American Samoa or Puerto Rico

#### **AND**

##### **2) You have an interest in a “*specified foreign financial asset*”, i.e.:**

- Any **financial account** maintained by a foreign financial institution, except for a U.S. branch of a foreign financial institution.
  - An account at a foreign branch of a U.S. financial institution is not a specified foreign financial asset.
- Other **foreign financial assets** held for investment that are not in an account maintained by a US or foreign financial institution, namely:
  - **Stock or securities** issued by someone other than a U.S. person
  - Any **interest** in a foreign entity, and
  - Any **financial instrument or contract** that has as an issuer or counterparty that is other than a U.S. person.

#### **AND**

##### **3) The *aggregate value* of all your specified foreign financial assets is more than the following applicable *reporting thresholds*:**

- **Unmarried taxpayers living in the US:** The total value of your specified foreign financial assets is more than:
  - \$50,000 on the last day of the tax year or
  - \$75,000 at any time during the tax year
- **Married taxpayers filing a joint income tax return and living in the US:** The total value of your specified foreign financial assets is more than:
  - \$100,000 on the last day of the tax year or
  - \$150,000 at any time during the tax year
- **Married taxpayers filing separate income tax returns and living in the US:** The total value of your specified foreign financial assets is more than:
  - \$50,000 on the last day of the tax year or
  - \$75,000 at any time during the tax year.
- **Taxpayers living abroad filing a return other than a joint return:** The total value of your specified foreign assets is more than:
  - \$200,000 on the last day of the tax year or
  - \$300,000 at any time during the year
- **Taxpayers living abroad filing a joint return:** The total value of your specified foreign assets is more than:
  - \$400,000 on the last day of the tax year or
  - \$600,000 at any time during the year

**Exceptions/Special Rules:**

If you *do not have to file a Form 1040* for the tax year, you do not need to file Form 8938, even if the value of your specified foreign assets is more than the appropriate reporting threshold.

If you are required to file a Form 8938 and you have a specified foreign financial asset that is reported on *Form 3520, Form 3520-A, Form 5471, Form 8621, Form 8865, or Form 8891*, you do not need to report the asset on Form 8938. However, you must identify on Part IV of your Form 8938 which and how many of these form(s) report the specified foreign financial assets.

- Even if a specified foreign financial asset is reported on a form listed above, you must still include the value of the asset in determining whether the aggregate value of your specified foreign financial assets is more than the reporting threshold that applies to you.

## Chapter 3:

### Page 1: IRS Issues sec. 263(a) Capitalization Regulations

#### Temporary Regulations on Capitalization of Costs for Tangible Property T.D. 9564 (12/23/2011)

Two days before Christmas, the IRS issued long-awaited regulations establishing new guidelines to be applied in determining which costs must be capitalized in connection with the acquisition, production, or improvement of tangible property. These regulations take the form of temporary regs, effective on January 1, 2012. They are massive in scope—over 200 pages in length and including 135 separate examples. The objective of the new guidance is to clarify this difficult area of the law, by providing more definitive guidelines, including safe harbors, for distinguishing those costs that must be capitalized from those that may be currently deducted as expenses.

A full exposition of these regulations is impossible, given the time constraints of this class. Following is an outline of the new rules, emphasizing the most significant points that practitioners must be aware of for applying these rules to client tax returns this busy season.

#### Highlights:

- ***\$100 Rule:*** Any item costing \$100 or less can be treated as “materials and supplies” expense rather than a capital asset.
- ***De Minimis Rule:*** A taxpayer that issues audited financial statements on which it expenses items below a prescribed dollar amount in accordance with an established accounting policy may expense those same items on its tax returns, up to a maximum aggregate amount equal to the greater of 0.1 percent of the taxpayer's gross receipts for the year or 2 percent of the taxpayer's total depreciation and amortization expense for the year.
- ***Optional Regulatory Accounting Method:*** Regulated taxpayers issuing financial statements subject to the regulatory accounting rules of the Federal Energy Regulatory Commission, the Federal Communications Commission, or the Surface Transportation Board may use their book methods for capitalizing expenditures.
- ***Loss Allowed on Disposition of a Building Component:*** The new regulations allow taxpayers to write off the adjusted basis of a structural component of a building (e.g., a roof) that is retired prior to the disposition of the entire building.
- ***Inherently Facilitative Amounts:*** The regulations establish a list of certain costs (e.g., appraisal fees) that are deemed to be facilitative of an asset acquisition and therefore capitalized into the acquisition cost of the asset.
- ***Investigative Expenses:*** Where a taxpayer incurs costs investigating multiple sites/options for a project, the costs of investigating the sites/options not acquired are no longer required to be capitalized into the cost of the site/option that is acquired.
- ***Pre-Placed-in-Service Expenses:*** Otherwise deductible repair expenses incurred in connection with an acquired asset prior to the time it is placed in service must be capitalized as an acquisition cost of the asset.
- ***Employee Compensation and Overhead:*** The regulations provide that any employee compensation and/or overhead allocable to the cost of acquiring tangible property may generally be deducted as an operating expense. Capitalization is required only where such costs are incurred to acquire intangible assets or inventory.

- **Removal Costs:** Costs of removing a retired depreciable asset are currently deductible, even where the retirement and removal occur in connection with the installation of a replacement asset.
- **Plan of Rehabilitation Rule Eliminated:** The regulations eliminate the rule that otherwise deductible repair expenses must automatically be capitalized if they are incurred in connection with a larger plan of rehabilitation for a building or asset.
- **Refreshing Retail Buildings:** The regulations provide that costs incurred to update and remodel a retail building in order to “refresh” its appearance do not have to be capitalized, if they do not result in an improvement of the building.
- **Safe Harbor for Routine Maintenance:** For assets other than buildings, taxpayers may deduct the cost of activities to keep the asset in ordinarily efficient operating condition, if such activities are expected to be performed more than once during the ADR class life of the asset.
- **Casualty Loss Rule:** The regulations refute the position that a taxpayer can claim a current deduction for the cost of repairing an asset for which a casualty loss deduction has been claimed.

### Detailed Discussion

#### Materials and Supplies

The regulations define “materials and supplies” costs that are treated as deductible expense items, rather than as capital expenditures. *Reg. sec. 1.162-3T*. These costs are written off as expenses in the year the materials or supplies are used. If the taxpayer does not keep track of the use of the items (“incidental” materials and supplies), the costs of the items are expensed when paid for or incurred. Materials and supplies are defined for this purpose as:

- 1) A *component acquired to maintain, repair, or improve a unit of tangible property* (e.g., a new window to replace a broken window in a building);
- 2) *Fuel, lubricants, water, and similar items*, that are reasonably expected to be consumed in 12 months or less;
- 3) A unit of property that has an *economic useful life of 12 months or less*; or
- 4) A unit of property that has *an acquisition cost or production of \$100 or less*.

**\$100 Rule:** The final category covers any type of property—even *long-lived assets* not normally thought of as supplies. The regulations include examples of involving office chairs, briefcases, and fax machines, as well as small items held for rental to customers by a rental company. A taxpayer may elect to capitalize the cost of these material and supplies instead of deducting them.

If a material or supply is used to *improve—as opposed to repair*—another item of property (under the rules that are explained below) then its cost must be capitalized as a cost of the larger improved property.

**Optional Accounting Method for Rotable Spare Parts:** The regulations establish a special optional accounting method for materials and supplies consisting of so-called “rotable spare parts”—i.e., parts that are acquired for installation on a unit of property, and that are removable from that unit of property, and are generally repaired or improved, and either reinstalled on the same or other property or stored for later installation. An example is copier parts maintained by a copier company.

- In 2007, the IRS issued *Rev. Proc. 2007-48*, establishing a safe harbor method of accounting for such parts as *depreciable assets*.

- **Reg. sec. 1.162-3T (e)** now establishes an optional method of accounting for these parts as materials and supplies. Under this elective accounting method:
  - a) the cost of the rotatable part is expensed when installed on a unit of property,
  - b) the FMV of the part is recognized as income and set up as the basis of the part at the time it is later removed from the unit of property,
  - c) the cost of repairing/reconditioning the rotatable part is added to its basis,
  - d) the basis of the rotatable part is expensed when it is reinstalled on a unit of property (along with the cost of reinstalling the part), and
  - e) if a rotatable part is discarded, its basis (if any) is written off at that time.

### **De Minimis Rule**

In addition to the \$100 rule for materials and supplies, the regulations provide a second safe harbor rule for small ticket items acquired by taxpayers that issue audited financial statements. **Reg. sec. 1.263(a)-2T(g)**. Under this *de minimis* rule, a taxpayer is not required to capitalize amounts paid for the acquisition or production of a unit of property if --

- 1) The taxpayer has an **applicable financial statement**;
- 2) The taxpayer has at the beginning of the taxable year **written accounting procedures treating as an expense for non-tax purposes the amounts paid for property costing less than a certain dollar amount**; and
- 3) The taxpayer **treats the amounts paid during the taxable year as an expense on its applicable financial statement** in accordance with its written accounting procedures.

The **maximum amount** a taxpayer may expense under this *de minimis* rule in any taxable year is limited to the **greater of**:

- a) **0.1 percent of the taxpayer's gross receipts** for the taxable year, as determined for federal income tax purposes; or
- b) **2 percent of the taxpayer's total depreciation and amortization expense** for the taxable year, as determined in its applicable financial statement.

The regulations provide that this rule cannot be used for amounts paid for property that is or is intended to be included in inventory property or for amounts paid for land.

A taxpayer may elect to deduct the cost of **materials and supplies** under this *de minimis* rule, rather than under the \$100 rule explained above. This election can accelerate the deduction for materials and supplies, as the *de minimis* rule allows costs to be written off when paid, rather than when the purchased item is actually used in the business.

**Applicable Financial Statement:** In order to take advantage of the *de minimis* rule, a taxpayer must have an “applicable financial statement”, defined as:

- A financial statement required to be filed with the **Securities and Exchange Commission**;
- A **certified audited financial statement** that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for --
  - Credit purposes;
  - Reporting to shareholders, partners, or similar persons; or
  - Any other substantial non-tax purpose;
- A financial statement (other than a tax return) required to be provided to the **federal or a state government or any federal or state agencies** (other than the SEC or the IRS).

Taxpayers without one of the above statements are not allowed to use a *de minimis* rule other than the \$100 materials and supplies rule for accounting for small purchases.

**Example 1:** X purchases 10 printers at \$200 each for a total cost of \$2,000. X issues an applicable financial statement and has a written policy at the beginning of the taxable year to expense amounts paid for property costing less than \$500. X treats the amounts paid for the printers as an expense on its applicable financial statement.

- If the aggregate amounts treated as *de minimis* and not capitalized by X including the amounts paid for the printers, do not exceed the greater of 0.1% of total gross receipts or 2% of X's total financial statement depreciation, X is not required to capitalize the \$2,000 amounts paid for the printers.

**Example 2:** X is a corporation that has an applicable financial statement and a written policy at the beginning of the taxable year to expense amounts paid for property costing \$500 or less. X purchases 200 computers at \$500 each for a total cost of \$100,000. In addition, X purchases 200 office chairs at \$100 each for a total cost of \$20,000 and 250 briefcases at \$80 each for a total cost of \$20,000. X also acquires 10 books at \$100 each. X makes an election to apply the *de minimis* rule to the office chairs and briefcases, but does not make that election for the books. X expenses the books as materials and supplies. X treats the amounts paid for the computers, office chairs, and briefcases as expenses on its applicable financial statement.

- For the taxable year, X has gross receipts of \$125,000,000 and reports \$7,000,000 of depreciation and amortization on its applicable financial statement. Thus the threshold for the *de minimis* rule is the greater of 0.1% of X's total gross receipts of \$125,000,000—i.e., \$125,000, or 2% of X's total depreciation and amortization of \$7,000,000—i.e., **\$140,000**.
- X paid a total \$140,000 (\$100,000 + \$20,000 + \$20,000) for the computers, office chairs, and briefcases, and can expense this amount under the *de minimis* rule.

### **Optional Regulatory Accounting Method**

**Reg. sec. 1.263(a)-3T(k)** allows certain taxpayers that issue financial statements subject to a regulatory accounting method to use the same accounting method to determine whether amounts paid to repair, maintain, or improve tangible property are to be treated as deductible expenses or capital expenditures. For a taxpayer that elects to use this option, the other rules and safe harbors in these regulations do not apply.

The regulatory accounting method election is available only to taxpayers subject to the regulatory accounting rules of the:

- Federal Energy Regulatory Commission,
- Federal Communications Commission, or
- Surface Transportation Board.

### **Acquisition Costs**

The regulations provide guidelines and rules governing which costs must be treated as costs of acquiring an asset under IRC sec. 263.

**Transaction Costs:** In an attempt to provide “bright line” guidance on the issue acquisition costs that are required to be capitalized, the regulations enumerate the following “*inherently facilitative costs*” paid in the process of investigating or otherwise pursuing the acquisition of an asset, that are deemed to be part of the cost of acquiring the asset:

- **Transporting** the property (for example, shipping fees and moving costs);
- Securing an **appraisal** or determining the value or price of property;
- **Negotiating the terms** or structure of the acquisition and **obtaining tax advice** on the acquisition;
- **Application fees, bidding costs**, or similar expenses;
- **Preparing and reviewing the documents** that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);
- **Examining and evaluating the title** of property;
- Obtaining **regulatory approval** of the acquisition or securing permits related to the acquisition, including application fees;
- Conveying property between the parties, including **sales and transfer taxes, and title registration costs**;
- **Finders' fees or brokers' commissions**, including amounts paid that are contingent on the successful closing of the acquisition;
- **Architectural, geological, engineering, environmental, or inspection services** pertaining to particular properties; or
- Services provided by a **qualified intermediary or other facilitator** of an exchange under section 1031.

Other investigative costs beyond the enumerated items may also be included as acquisition costs. The regulations use the example of fees paid by a law firm to an interior designer to “shop for, evaluate, and make recommendations” regarding the purchase of a new conference table.

**“Pre-Decisional” Costs of Acquiring Real Estate:** The regulations permit expensing of costs not on the above list of inherently facilitative costs, if they are incurred in activities performed in the process of **determining whether to acquire real property and which real property to acquire**. Reg. sec. 1.263(a)-2T(f)(2)(iii).

**Costs Allocable to Abandoned Acquisitions:** The regulations reverse the existing rule regarding the treatment of investigative costs where a taxpayer is considering multiple mutually-exclusive acquisition candidates and ultimately acquires only one asset. The **transaction costs allocated to an asset that is not acquired** may be written off as expense when the decision is made not to acquire the asset. The costs are **not** added to the cost of the asset that the taxpayer does decide to acquire.

**Example 3:** X owns several retail stores. X decides to examine the feasibility of opening a new store in city A. In Year 1, X hires and incurs costs for a development consulting firm to study city A and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that X should consider for purposes of locating a new store. In December, Year 1, X continues to consider whether to purchase real property in city A and which property to acquire. X hires, and incurs fees for, an appraiser to perform appraisals on two different sites to determine a fair offering price for each site.

In Year 2, X decides to acquire one of these two sites for the location of its new store. At the same time, X determines not to acquire the other site.

- X is not required to capitalize amounts paid to the development consultant in Year 1 because these are “pre-decisional costs” incurred in the process of determining whether to acquire real property and which real property to acquire and the amounts are **not** inherently facilitative costs under the regulations.
- However, X must capitalize amounts paid to the **appraiser** in Year 1 because appraisal costs are enumerated as “inherently facilitative cost”.
- In Year 2, X must include the appraisal costs allocable to property that was acquired in the basis of that property, but may write off the appraisal costs allocable to the property that was not acquired.

**Work Performed on Acquired Assets Prior to Placement in Service:** The regulations provide that the cost of acquiring an asset includes all costs for work performed on the asset prior to the date the asset is placed in service by the taxpayer.

**Example 4:** X purchases a building for use as a business office. Prior to placing the building in service, X incurs costs to repair cement steps, refinish wood floors, patch holes in walls, and paint the interior and exterior of the building.

- Although the work that X performs does not constitute an improvement to the building or its structural components, the amounts paid must nonetheless be capitalized as costs of acquiring the building, because they were for work performed prior to X's placing the building in service.

**Example 5:** X purchases a new machine for use in an existing production line of its manufacturing business. After the machine is installed, X performs a critical test on the machine to ensure that it will operate in accordance with quality standards. Once the critical test is complete, X places the machine in service on the production line. X performs periodic quality control testing after the machine is placed in service.

- The amounts paid for the installation and the critical test performed before the machine is placed in service must be capitalized as a cost of acquiring the machine.
- Amounts paid for periodic quality control testing *after* X placed the machine in service may be deducted as operating expenses.

**Employee Compensation & Overhead Costs:** The regulations in sec. 1.263(a)-4 dealing with the capitalization of costs related to *intangible* assets require taxpayers to capitalize employee compensation and overhead allocable to the acquisition of such assets. However, new reg. sec. 1.263(a)-2t(f)(2)(iv) provides that this rule generally does *not* apply to such costs allocable to the purchase of *tangible* property. Capitalization of wages and overhead is only required where such costs are allocable to the acquisition of *inventory* or to the *production* of tangible property by the taxpayer,

**Example 6:** X, a freight carrier, maintains an acquisition department whose sole function is to arrange for the purchase of vehicles and aircraft from manufacturers or other parties to be used in its freight carrying business.

- X is *not* required to capitalize any portion of the compensation paid to employees in its acquisition department or any portion of its overhead allocable to its acquisition department. However, X may *elect* to capitalize these costs allocable to the acquisition of a vehicle or aircraft on its tax return.

**Removal Costs:** The regulations do not address the tax treatment of the cost of *removing* an asset that is replaced by a new asset. The preamble to the regulations notes that such costs generally do not have to be capitalized as part of the cost of the new asset. Instead, the removal costs may be written off as a cost of retiring the old asset (citing *Rev. Rul. 2000-7*). However, if a component of a property is removed in connection with an *improvement* of the property, the cost of removing the component must be capitalized into the cost of the improvement.

### **Disposition of a Component of an Asset**

Because the MACRS depreciation system does not allow for component depreciation, existing regulations specifically provided that a taxpayer could not treat a *portion of an asset* as being disposed of for purposes of recognizing a loss. Thus, for example, when a taxpayer replaced a roof on a building, the taxpayer could not write off the adjusted basis allocable to the roof that was removed and replaced. The new regulations change this rule. **Reg. sec. 1.168(i)-8T(g)(3)** allows a taxpayer that disposes of a

component of an asset to carve out of the pro rata share of the adjusted basis of the larger asset that is allocable to the component that is disposed of. This adjusted basis can be written off as a loss on the retirement of the component. The regulations allow the taxpayer to use “*any reasonable method*” to determine the basis allocable to the component.

The regulations include an example involving the replacement of an elevator in a \$20 million office building. The taxpayer reasonably estimates \$150,000 as the cost allocable to the elevator and adjusts this amount for the elevator’s pro rata share of the depreciation claimed on the building as a whole, to arrive at the adjusted basis of the elevator that was replaced. This amount is deducted by the taxpayer as a loss on disposition of the elevator.

**Exceptions:** Carve-outs are not permitted for any portion of an asset that is assigned to asset classes 00.11 through 0.4 of *Rev. Proc. 87-56*:

- office furniture and equipment,
- cars, trucks and buses
- non-commercial aircraft, trains, and boats
- land improvements such as bridges, wharves, fencing, landscaping

**Example 7:** C owns several pick-up trucks that are used in its trade or business. C replaces the engine on one of the trucks with a new engine and treats each engine of a truck as a major component of the truck.

- Because the trucks are light general purpose trucks described in asset class 00.241 of *Rev. Proc. 87-56*, C must treat each truck as the asset for tax disposition purposes—it cannot carve out the engine as a separate component.
- Thus, the replacement of the engine on the truck is not treated as a disposition of the engine. As a result, depreciation continues for the cost of the truck (including the cost of the replaced engine) and C does not recognize a loss upon this replacement.

A component of an asset can also not be carved out if it is an asset that a taxpayer assigns to a **MACRS class of 3, 5, 7, 10 or 15 years**, except for 15-year property that includes buildings or structural components (such as retail motor fuels outlet or qualified restaurant property). If a taxpayer assigns a different MACRS class to a component of a larger property, then the component can be treated as a separate asset for disposition purposes. See Example 8 below.

### **Improvements vs. Repairs**

The most troublesome capitalization issues arise in the distinctions between costs that are considered as *improving* property as opposed to cost that are incurred to merely *repair* property. Although the new regulations attempt to bring some clarity to this debate by establishing new guidelines, it is apparent after studying the new rules that this will continue to be an area of dispute.

### **Definition of a “Unit of Property”**

The starting point in analyzing whether an expenditure improves or merely repairs an asset is the definition of the specific “unit of property” under consideration. If a taxpayer works on the roof of a building, is the unit of property the roof or the entire building? If the taxpayer reconditions the engine of a truck, is the unit of property the engine or the truck? This determination can be pivotal, because work that “improves” a component of a larger property may not be significant enough to improve the larger property as a whole.

The regulations establish specific rules for defining the unit of property that is to be used for evaluating whether a cost incurred results in a capital improvement.

**Unit of Property--Buildings:** For buildings, the regulations define the building as a single unit of property. However, the building is divided separate sub-units to be analyzed in applying the improvement standards: the “building structure” and eight separate “building systems”. Any expenditure which improves either the building structure or any of the individual building systems is deemed to improve the building as a whole, and must therefore be capitalized.

**“Building Structure”:** The building structure is a single unit of property, consisting of the building and its structural components, other than the structural components designated as buildings systems.

**“Building Systems”:** Each of the following structural components constitutes a “building system” that is a unit of property separate from the building structure, and to which the improvement rules must be separately applied:

- 1) Heating, ventilation, and air conditioning (“*HVAC*”) *systems* (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators);
- 2) *Plumbing systems* (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures);
- 3) *Electrical systems* (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from property line to and between buildings and other permanent structures);
- 4) All *escalators*;
- 5) All *elevators*;
- 6) *Fire-protection and alarm systems* (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire-fighting equipment, such as extinguishers, hoses);
- 7) *Security systems* for the protection of the building and its occupants (including window and door locks, *security* cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit);
- 8) *Gas distribution system* (including associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures).

**Unit of Property—Other Than Buildings:** For real or personal property other than buildings, all the *components that are functionally interdependent comprise* a single unit of property. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

**Example 7:** X owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries and trucks. The locomotive is a single unit of property because it consists entirely of components that are functionally interdependent.

- Thus the evaluation of whether any work on the locomotive results in an improvement is based upon the effect of the work on the locomotive as a whole.

**Exception for Assets Separately Depreciated:** Notwithstanding this general definitional rule, *reg. sec. 1.263(a)-3T(e)(5)* provides that interdependent components of an asset are treated separate units of property if at the time the taxpayer placed the asset in service, the taxpayer treated a component of the asset as being in a different MACRS class from the asset as a whole, or used different depreciation methods for the component and the asset of which it is a part.

**Example 8:** T owns a fleet of truck tractors and trailers used in its business of transporting freight. Each tractor and trailer is comprised of various components, including tires. T purchased a truck tractor with all of its components, including tires. The tractor tires have an average useful

life to T of more than one year. At the time T placed the tractor in service, it treated the tractor tires as a separate asset for depreciation purposes. T properly treated the tractor (excluding the cost of the tires) as 3-year MACRS property and the tractor tires as 5-year MACRS property.

- Under the general rule, T must treat the tractor, including its tires, as a single unit of property because the tractor and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the tractor).
- However, under the special exception, T must treat the tractor and tires as separate units of property, because T properly treated the tires as being within a different class of property for MACRS depreciation.

**Special Rule--Plant Property:** In the case of functionally interdependent machinery or equipment used to perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities (“plant property”), the unit of property is divided into smaller units comprised of each component (or group of components) that performs a **discrete and major function or operation** within the functionally interdependent machinery or equipment.

**Example 9:** X is engaged in a uniform and linen rental business. X owns and operates a plant that utilizes many different machines and equipment in an assembly line-like process to treat, launder, and prepare rental items for its customers. X utilizes two laundering lines in its plant, each of which can operate independently. One line is used for uniforms and another line is used for linens. Both lines incorporate several sorters, boilers, washers, dryers, ironers, folders, and waste water treatment systems.

- The **initial units of property are each laundering line** because each line is functionally independent and is comprised of components that are functionally interdependent.
- However, because each line is comprised of plant property, X must further divide these initial units of property into smaller units of property by determining the components (or groups of components) that perform **discrete and major functions** within the line.
  - X must treat each sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system in each line as a **separate unit of property** because each of these components performs a discrete and major function within the line.

### Definition of an Improvement:

Having defined the unit of property with respect to which costs are analyzed, the regulations next provide definitions of which costs must be capitalized as capital improvements to the unit of property. These definitions treat as capital improvements those amounts paid after the property is placed in service that:

- 1) **restore** a unit of property
- 2) result in a **betterment** of a unit property,, or
- 3) **adapt** a unit of property to a **new or different use**.

These three standards are further defined as follows.

### Restorations:

The most comprehensive type of “capital improvement” under the regulations is a “**restoration**” of a unit of property. Under **reg. sec. 1.263(a)-3T(i)**, an amount is paid to restore a unit of property **only if it --**

- 1) is for the **replacement of a component** of a unit of property that the taxpayer has **previously written off** through a loss deduction or recovered as basis on a sale or exchange;
- 2) is for the repair of damage to a unit of property for which the taxpayer has previously taken a basis adjustment as a result of a **casualty loss**;

- 3) returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is ***no longer functional for its intended use***;
- 4) results in the rebuilding of the unit of property to a ***like-new condition*** after the end of its class life; or
- 5) is for the replacement of a part or a combination of parts that comprise a ***major component*** or a ***substantial structural part*** of a unit of property.

***Replacement of a Loss Component:*** The first category of restoration is an amount paid to replace a component of the unit of property that has been disposed of and written off. This rule is tied to the change in the regulations explained above that now allows a taxpayer to claim a loss on the disposition of a component of an asset. Thus, if a taxpayer writes off the adjusted basis of a component of an asset (either as an abandonment loss or as basis in computing the gain or loss in a disposition of the component), then the cost of replacing that component is treated as a restoration that is a capital improvement.

***Restoration after Casualty Loss:*** The regulations reject the position advocated by some commentators that the write-off of the basis of an asset in connection with a casualty loss should not automatically dictate capitalizing costs to repair the damage to the asset. The preamble to the regulations discusses this issue at length and concludes that it is not appropriate to allow business taxpayers to deduct the cost of repairing damage for which a casualty loss has already been claimed.

***Example 10:*** X owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has an adjusted basis of \$500,000. X deducts under section 165 a casualty loss in the amount of \$50,000 and properly reduces its basis in the office building to \$450,000. X hires a contractor to repair the damage to the building and pays the contractor \$50,000 for the work.

- X must capitalize the \$50,000 amount paid to the contractor, because X previously adjusted its basis in that amount as a result of a casualty loss.

***Example 11:*** Assume the same facts as in Example 10, except that X receives insurance proceeds of \$50,000 after the casualty to compensate for its loss. X cannot deduct a casualty loss under section 165 because its loss was compensated by insurance. However, X properly reduces its basis in the property by the amount of the insurance proceeds.

- X must capitalize the \$50,000 amount paid to the contractor because X has properly taken a basis adjustment relating to a casualty event.

***Restoration of a Non-Functional Asset:*** As explained below in connection with the “routine maintenance” safe harbor and the “building refreshment” rules, a taxpayer can treat significant expenditures to maintain a property in working condition as deductible expenses. However, if the property has been allowed to fall into such a state of disrepair that it is ***no longer functional for its intended use***, then expenditures to restore the property to functionality must be capitalized, as the expenditures create an economic asset where none existed previously.

***Example 12:*** F owns and operates a farm with several barns and outbuildings. X did not use or maintain one of the outbuildings on a regular basis, and the outbuilding fell into a state of disrepair. The outbuilding previously was used for storage but can no longer be used for that purpose because the building is not structurally sound. F decides to restore the outbuilding and pays an amount to shore up the walls and replace the siding.

- X must treat the amount paid to shore up the walls and replace the siding as a restoration of the building structure, because the amounts return the building structure to its ordinarily

efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use.

- Therefore, X must treat the amount paid as an improvement to the building and must capitalize the amount paid.

**Restoration to “Like-New” Condition:** This rule is a variation of the previous one, in that it requires capitalization of expenditures deemed to create a new asset in the place of an existing asset that has exhausted its usefulness. It is triggered when a taxpayer incurs costs to bring a unit of property to the status of “*new, rebuilt, remanufactured, or similar status*” under the terms of any federal regulatory guideline or the manufacturer’s original specifications” after the end of the applicable *ADR class life* for the asset.

**Example 13:** R is a railroad that owns a fleet of freight cars that have a MACRS recovery period of 7 years and an ADR class life of 14 years. Every 8 to 10 years, R rebuilds its freight cars. Ten years after R places the freight car in service, R performs a “rebuild”, which includes a complete disassembly, inspection, and reconditioning or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. R modifies the car to upgrade various components to the latest engineering standards. The freight car essentially is stripped to the frame, with all of its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight car are replaced or are sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled. At the end of the rebuild, the freight car has been restored to rebuilt condition under the manufacturer’s specifications. Assume the freight car is the unit of property.

- R is not required to capitalize the amounts paid to rebuild the freight car as a restoration because, although the expenditures restored the freight car to like-new condition, the amounts were not paid after the end of the ADR class life of the freight car.
  - If R had done this same work in year 15, it would have been required to capitalize the expenditures as restoration costs.

**Replacement of a Major Component or Substantial Structural Part:** Although the year-10 rebuild of the freight car in the example just discussed does not result in a “like-new” restoration, it may still result in a capitalizable restoration if the work involves is the replacement of a “major component or substantial structural part of a unit of property.” Under this test, the cost of replacing a component of a unit of property must be capitalized *even if it does not result in a “betterment”* of the unit of property or *adapt it to a new use*, under the standards discussed below. If the component is “major” or a “substantial structural part”, the cost of replacing it is a capital expenditure, period.

So the issue that will be a bone of contention under the new regs is the determination of what constitutes a “major component” or a “substantial structural part.” **Reg. sec. 1.263(a)-3T(i)(3)** provides:

“To determine whether an amount is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property, it is appropriate to consider all the facts and circumstances. These facts and circumstances include the *quantitative or qualitative significance* of the part or combination of parts in relation to the unit of property. A major component or substantial structural part includes a part or combination of parts that comprise a *large portion of the physical structure* of the unit of property or that perform a *discrete and critical function in the operation* of the unit of property. However, the replacement of a minor component of the unit of property, even though such component may affect the function of the unit of property, will not generally, by itself, constitute a major component or substantial structural part.”

The following example illustrates a rather straightforward application of this standard.

**Example 14:** P is a common carrier that owns a fleet of petroleum hauling trucks. P pays amounts to replace the existing engine, cab, and petroleum tank with a new engine, cab, and tank. Assume the tractor of the truck (which includes the cab and the engine) is a single unit of property, and that the trailer (which contains the petroleum tank) is a separate unit of property.

- The new engine and cab constitute parts or combinations of parts that comprise a major component or substantial structural part of P's tractor.
  - Therefore, the amounts paid for the replacement of those components must be capitalized as restorations.
- The new petroleum tank constitutes a part or combination of parts that comprise a major component and a substantial structural part of the trailer.
  - Accordingly, the amounts paid for the replacement of the tank also must be capitalized as restorations.

The “substantial structural part” test brings into play everyone’s favorite example, which is the **replacement of a roof on a building**. The IRS addresses this issue with the following not-too-helpful examples in the regulations:

**Example 15:** X owns a large retail store. X discovers a leak in the roof of the store and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the sheathing and rafters has rotted, and recommends the **replacement of the entire roof**. X pays the contractor to replace the entire roof with a new roof.

- The roof comprises a major component or substantial structural part of X's building structure. X must treat the amount paid to replace the roof as a restoration because X paid the amount to replace a major component or substantial structural part of X's building structure. Therefore, X must treat the amount paid to restore the building structure as an improvement to the building and must capitalize the amount paid.

**Example 16:** Assume the same facts as Example 15 except the contractor recommends replacement of a **significant portion of the roof**, but not the entire roof. Accordingly, X pays an amount to replace a large portion of the decking, insulation, and membrane of the roof of X's retail building.

- The portion of the roof replaced comprises a major component or substantial structural part of the building structure. Thus, X must treat the amount paid for the roof work as a restoration of the building structure because X paid the amount to replace a major component or substantial structural part of the building structure.

**Example 17:** M is in the business of manufacturing parts. M owns a factory facility in which the parts are manufactured. The roof over M's facility is comprised of structural elements, insulation, and a waterproof membrane (think flat roof with Armstrong foam or other synthetic coating). Over time, the waterproof membrane began to wear and leakage began to occur. Consequently, M pays an amount **to replace the plant's worn roof membrane** with a similar but new membrane.

- Although the roof membrane may affect the function of the building structure, it is not, by itself, a major component or substantial structural part of X's building. Because the roof membrane is not a major component or substantial structural part of the building structure, X is not required to treat the amount paid to replace the roof membrane as a restoration of the building structure.

A further example expands upon this issue by addressing expenditures on only a **portion of a “building system”**—as opposed to work on a portion of the building structure:

**Example 18:** B owns an office building with an *HVAC system* that incorporates *10 roof-mounted units* that provide heating and air conditioning for different parts of the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior. B begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that B *replace two of the roof-mounted units*. B pays an amount to replace the two specified units. No work is performed on the other 8 roof-mounted heating/cooling units, the duct work, or the controls.

- The HVAC system is a “building system” under the unit of property rules. The two roof-mounted heating/cooling units, by themselves, do not comprise a large portion of the physical structure of the HVAC system or perform a discrete and critical function in the operation of the system.
- Therefore, the two units do not constitute a major component or substantial structural part of the building system. Accordingly, B is not required to treat the amount paid to replace the two roof-mounted heating/cooling units as a restoration of a building system.

Other examples in the regulations of work that does (or does not) constitute replacement of a major component which must be capitalized as a “restoration” include:

- replacement of a furnace (major component of HVAC building system)
- replacement of a sprinkler system in a building with a new sprinkler system
- replacement of the wiring throughout a building with new wiring that meets building code requirements
- updating the restrooms in a retail building by replacing the plumbing fixtures in all of the restrooms, including the toilets, sinks, and associated fixtures, with modern style plumbing fixtures of similar quality and function
  - replacement of 2 out of 20 sinks *not* a major component
- replacement of 200 out of a total of 300 windows in an office building
  - replacement of 30 out of 300 windows *not* a major component
- replacement of the wood floors in all of public areas of a hotel
  - replacement of wood floors in hotel lobby only *not* a major component

While it is easy to state the “major component” definition, it is a safe prediction that taxpayers and the IRS will often disagree on how the definition applies to a particular fact pattern. The new rule sharpens the focus of the debate, but the debate will no doubt continue with taxpayers arguing that a project did not result in the replacement of a “major component” of a building or other asset.

If it is agreed that the work done on a unit of property did not result in the replacement of a major component or a substantial structural part of the property, the inquiry is not over. This means only that the work did not result in the “restoration” of the asset. The taxpayer must still determine whether work resulted in the “betterment” of the unit of property or adapted it to a new use.

### **Betterments:**

Under *reg. sec. 1.263(a)-3T(h)*, work done on a unit of property results in a “betterment” of the property only if it:

- *Ameliorates a material condition or defect that existed prior to the taxpayer's acquisition of the unit of property* (or that arose during the production of the unit of property), whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;

- Results in *a material addition* (including a physical enlargement, expansion, or extension) to the unit of property; or
- Results in *a material increase in capacity, productivity, output, efficiency, strength, or quality* of the unit of property.

**Betterment Compared to What?:** The determination of whether an expenditure results in a betterment of the unit of property is made by comparing the condition of the property immediately after the expenditure with the *condition of the property immediately prior to the circumstances necessitating the expenditure*.

- If the expenditure is made as a result of a *particular event*, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to the particular event.
- If the expenditure is made to correct the effects of *normal wear and tear* to the unit of property (including the amelioration of a condition or defect that existed prior to the taxpayer's acquisition of the unit of property resulting from normal wear and tear), the condition of the property is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property *when placed in service by the taxpayer*.

**Pre-Existing Defects—Environmental Clean-Up:** The preamble to the regulations notes that the IRS rejected requests for more lenient expensing standards for environmental clean-ups. While a taxpayer can expense the cost of cleaning up *its own* environmental damage to a property, it must capitalize the cost of remediating an environmental hazard that *existed at the time it acquired the property*—even if the taxpayer is reacquiring a property with an environmental problem that the taxpayer caused during an earlier period of ownership. (The preamble notes that IRC sec. 198 may allow for deduction of certain remediation costs that would otherwise be capital expenditures under the general rules of these regulations.)

- The regulations offer the example the cost of cleaning up land acquired with *a leaking underground storage tank* as an illustration of a betterment due to the amelioration of a material defect that existed at the time of acquisition.
- The regulations use *asbestos removal* from a building as an example of environmental remediation that does not involve the amelioration of a material defect. The justification for this distinction is that “the health dangers of asbestos were not widely known when the building was constructed.” Because the replacement of the asbestos insulations does not increase the capacity, productivity, efficiency, strength, or quality of the building structure, the cost of the remediation can be expensed.

**Replacement Part Upgrades:** If a taxpayer needs to replace part of a unit of property that cannot practicably be replaced with the same type of part (for example, because of technological advancements or product enhancements), the replacement of the part with an improved, but comparable, part does *not*, by itself, result in a betterment to the unit of property.

**Routine Maintenance Safe Harbor:** An amount paid for routine maintenance performed on a unit of property *other than a building or a structural component of a building* is deemed *not* to improve that unit of property. Reg. sec. 1.263(a)-3T(g). “Routine maintenance” consists of the *recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition*.

- Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of parts of the unit of property with comparable and commercially available and reasonable replacement parts.

The activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably *expects to perform the activities more than once during the ADR class life* of the unit of property.

- Among the factors to be considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statement.
- The regulations include an example of a container with a 12-year life used in metal refining that has a lining which must be replaced every 3 years. Even though the lining comprises 60% of the structure of the container, its periodic replacement constitutes routine maintenance.
  - **Caution:** Remember that under the “restoration” rule, replacement of a major component results in a capital improvement, even though the work to replace that component might qualify as “routine maintenance”.

Routine maintenance does not include *scheduled maintenance that is required due to a prior owner's use of the property*. The regulations use the example of a machine that has a life of 10 years and requires maintenance every 3 years. If the taxpayer acquires the machine shortly before the scheduled 3 year maintenance date, the work done by the taxpayer does not qualify for the routine maintenance safe harbor. Instead, the nature of the maintenance must be evaluated to determine whether it results in a betterment of the machine.

If a property has deteriorated to a *state of disrepair such that it is no longer functional for its intended use*, no repair of that property will be considered routine maintenance. (See discussion of restorations above.)

**Building Refreshments:** Although the regulations *exclude building maintenance* from the “routine maintenance” safe harbor, they do allow for expensing of periodic costs incurred to “*refresh*” a building, depending upon facts and circumstances. This rule is illustrated by the following two examples:

**Example 19:** X owns a nationwide chain of retail stores that sell a wide variety of items. To remain competitive in the industry and increase customer traffic and sales volume, X periodically refreshes the appearance and layout of its stores. The work that X performs to refresh a store consists of cosmetic and layout changes to the store's interiors and general repairs and maintenance to the store building to make the stores more attractive and the merchandise more accessible to customers. The work to each store building consists of replacing and reconfiguring a small number of display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing vinyl flooring throughout the store building, and power washing building exteriors. In its applicable financial statement, X capitalizes all the costs to refresh the store buildings and amortizes them over a 5-year period.

- Considering the facts and circumstances, including the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on buildings' structure and systems, and the treatment of the work on X's applicable financial statements, the amounts paid for the refresh of each building do not result in material increases in capacity, productivity, efficiency, strength, or quality of the buildings' structures or any building systems as compared to the condition of the buildings' structures and systems after the previous refresh.
- Rather, the work performed keeps X's store buildings' structures and buildings' systems in the ordinary efficient operating condition that is necessary for X to continue to attract customers to its stores. Therefore, X is not required to treat the

amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments.

- However, X is required to capitalize the amounts paid to acquire and install display tables and the racks that constitute separate units of section 1245 property.

This “building refreshment” rule gets a little fuzzy when you consider the follow-up example from the regulation:

**Example 20:** Assume the same facts as Example 19, but assume that the work performed to refresh the stores directly benefits or was incurred by reason of a **substantial remodel** to X's store buildings. In addition to the reconfiguration, cosmetic changes, repairs, and maintenance activities, X performs significant additional work to alter the appearance and layout of its stores in order to increase customer traffic and sales volume.

- First, X pays amounts to upgrade the buildings' structures by removing and rebuilding walls to move built-in changing rooms and specialty departments to different areas of the stores, replacing ceilings with acoustical tiles to reduce noise and create a more pleasant shopping environment, rebuilding the interior and exterior facades around the main doors to create a more appealing entrance, replacing conventional doors with automatic doors, and replacing carpet with ceramic flooring of different textures and styles to delineate departments and direct customer traffic.
- Second, X pays amounts for work on the electrical systems, upgrading the wiring in the buildings so that X can add video monitors and an expanded electronics department. X also removes and replaces the recessed lighting throughout the buildings with more efficient and brighter lighting.
- In its applicable financial statement, X capitalizes all the costs incurred over a 10-year period. Upon completion of this period, X anticipates that it will have to remodel the store buildings again.
  - Considering the facts and circumstances, , including the purpose of the expenditure, the physical nature of the work performed, the effect of the work on the buildings' structures and buildings' systems, and the treatment of the work on X's applicable financial statements, the amounts that X pays for the remodeling of its stores result in betterments to the buildings' structures and electrical systems.
  - Specifically, amounts paid to upgrade the wiring and to remove and replace the recess lighting throughout the stores materially increase the productivity, efficiency, and quality of X's stores' electrical systems.
  - Also, the amounts paid to remove and rebuild walls, to replace ceilings, to rebuild facades, to replace doors, and replace flooring materially increase the productivity, efficiency, and quality of X's store buildings' structures.
  - In addition, the amounts paid for the refresh of the store buildings described in Example 19 must be capitalized because these expenditures directly benefitted or were incurred by reason of the improvements to X's store buildings' structures and electrical systems.

And the following further example illustrates that even where the “refresh” does not involve a wholesale remodel of the building, it may still require capitalizing the costs associated with improving individual building systems.

**Example 21:** Same facts, except that in the course of X's refresh of its stores, X pays amounts to remove and replace the bathroom fixtures (toilets, sinks, and plumbing fixtures) with upgraded bathroom fixtures in all of the restrooms in X's retail buildings in order to update the restroom

facilities. As part of the update of the restrooms, X also pays amounts to replace the floor and wall tiles that were removed or damaged in the installation of the new plumbing fixtures.

- As explained above, the plumbing system in each of X's store buildings, including the plumbing fixtures, is a "building system" which is treated as a unit of property separate from the building. Therefore, the betterment test is applied to the plumbing system, rather than to the building as a whole.
- X must treat the amounts paid to replace the bathroom fixtures with upgraded fixtures as a betterment because they result in a material increase in the quality of the plumbing system. Because the costs to remove the old plumbing fixtures and to remove and replace the bathroom tiles directly benefit and are incurred by reason of the improvement to the plumbing system, these costs must also be capitalized.

**Caution Repeat:** In applying the "building refresh" rule, one must first clear the hurdle of the "major component" rule—i.e., if the work to refresh the building involves the replacement of a major component of a building system, it will involve an improvement that has to be capitalized, even though there is no betterment to the building system under the building refresh rule.

**Elimination of Plan of Rehabilitation Rule:** One taxpayer-friendly change in the new regulations is the abandonment of the prior IRS position (which had been endorsed the courts) that otherwise deductible repair and maintenance costs are considered to be capital expenditures for the improvement of a unit of property if they are incurred in connection with an overall plan for the rehabilitation of the property. **Reg. sec. 1.263(a)-3T(f)(3)(I)** provides that "indirect costs that do not directly benefit and are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement."

**Retention of Rule for Personal Residences:** In a further taxpayer-friendly gesture, the regulation provides that: "A taxpayer who is an individual may capitalize amounts paid for repairs and maintenance that are made at the same time as capital improvements to units of property not used in the taxpayer's trade or business or for the production of income if the amounts are paid as part of a remodeling of the taxpayer's residence."

### **Adaptation to New or Different Use**

Finally, under **reg. sec. 1.263(a)-3T(j)** taxpayers must capitalize amounts paid to adapt a unit of property to a new or different use. In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is **not consistent with the taxpayer's intended ordinary use of the unit of property at the time it was originally placed in service by the taxpayer.**

**Example 22:** X is a manufacturer and owns a building that it has used for manufacturing since Year 1, when X placed it in service. In Year 30, X pays an amount to convert its manufacturing building into a showroom for its business. To convert the facility, X removes and replaces various structural components to provide a better layout for the showroom and its offices. X also repaints the building interiors as part of the conversion. None of the materials used are better than existing materials in the building.

- The amount paid to convert the manufacturing facility into a showroom adapts the building structure to a new or different use because the conversion is not consistent with X's intended ordinary use of the building structure at the time it was placed in service. Therefore, X must treat the amount paid for the adaptation of the building structure as an amount that improves the building.

**Example 23:** X owns a parcel of land on which it previously operated a manufacturing facility. Assume that the land is the unit of property. During the course of X's operation of the

manufacturing facility, the land became contaminated with wastes from its manufacturing processes. X discontinues manufacturing operations at the site, and decides to sell the property to a developer that intends to use the property for residential housing. In anticipation of selling the land, X pays an amount to clean up the land to a standard that is required for the land to be used for residential purposes. In addition, X pays an amount to regrade the land so that it can be used for residential purposes.

- Amounts that X pays to clean up wastes that were discharged in the course of X's manufacturing operations do not adapt the land to a new or different use, regardless of the extent to which the land was cleaned. Therefore, X is not required to capitalize the amount paid for the cleanup.
- However, the amount paid to regrade the land so that it can be used for residential purposes adapts the land to a new or different use that is inconsistent with X's intended ordinary use of the property at the time it was placed in service. Accordingly, the amounts paid to regrade the land must be capitalized as improvements.

### Chapter 3:

#### **Page 3-15: Continuing Care Retirement Community Buildings are 27.5-Year MACRS Property**

In *CCA 201147025* (11/25/2011) the IRS Chief Counsel's Office concluded that all of the buildings in a continuing care retirement community qualified as residential real property depreciable over a 27.5 year MACRS life.

The memo concludes that the various types of residential units (independent living, assisted living, Alzheimer's/memory support care, and skilled nursing care units) within the buildings that comprise are used to provide living accommodations for residents are "dwelling units" of the 80% gross rental income test of sec. 168(e)(2)(A). Moreover, the memo determined that the monthly "life care" fees paid by the residents constitutes payment for the use of, or the right to use, a dwelling unit, and constitutes rental income from that dwelling unit for purposes of applying the 80% test.

Since the facts indicated that the CCRC was not receiving any rents for commercial activities in the buildings, 80% or more of the rents were for the use of dwelling units and the properties therefore qualified as 27.5-year MACRS assets.

**Chapter 5:****Page 5-31: IRS Issues Proposed Regs on Classification of LLC Members for Passive Loss Purposes (11/28/2011)**

As explained in yesterday's session of the course, a taxpayer generally has several different ways of demonstrating material participation in an activity, in order to avoid having the activity be classified as "passive" under sec. 469. These tests are

- 1) The individual participates in the activity for more than 500 hours during the year;
- 2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals for the year;
- 3) The individual participates in the activity for more than 100 hours during the taxable year, and not less than the participation in the activity of any other individual for the year;
- 4) The activity is a "significant participation activity" (i.e., over 100 hours) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours.
- 5) The individual materially participated in the activity for any 5 taxable years during the 10 taxable years that immediately precede the taxable year;
- 6) The activity is a personal service activity, and the individual materially participated in the activity for any 3 taxable years preceding the taxable year.
- 7) Facts and circumstances.

Section 469(h)(2) generally treats losses from interests in limited partnerships as passive. However, reg. sec. 1.469-5T(e)(2) permits an individual taxpayer to establish material participation in a limited partnership, but only by meeting the 500-hour test, or one of the two look-back tests.

Disputes have arisen as to whether this same constraint applies limited liability company members. Several court decisions have concluded that it does not:

- *Garnett v. Comm'r*, 132 T.C. 368 (2009)
- *Thompson v. U.S.*, 87 Fed. Cl. 728 (2009)
- *Newell v. Comm'r*, TC Memo 2010-23

In each of these decisions an LLC member was allowed to use all of the material participation tests to demonstrate that an interest in an LLC was not a passive activity. The IRS has responded to these decisions by amending its regulations to redefine the circumstances in which a limited partner will be constrained to using only the 500-hour and look-back material participation tests:

"Recognizing that the original presumptions regarding the limitations on a limited partner's participation in the activities of the entity are no longer valid today, and also recognizing the emergence of LLCs, the proposed regulations eliminate the current regulations' reliance on limited liability for purposes of determining whether an interest is an interest in a limited partnership as a limited partner under section 469(h)(2) and instead adopt an approach that relies on the individual partner's right to participate in the management of the entity.

"Today, many states have adopted a variation of the Revised Uniform Limited Partnership Act of 1985 (RULPA). Under RULPA, limited partners may participate in the management and control of the partnership without losing their limited liability. As a consequence, limited partners under RULPA are now more akin to general partners and LLC members with respect to their rights in the management of the entity."

Under the proposed regulations an interest in an entity will be treated as an interest in a limited partnership for passive loss purposes only if “the holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity was organized and under the governing agreement. Rights to manage include the power to bind the entity.”

Thus for limited partners and LLC members alike, the standard for being allowed to use all of the material participation tests will be demonstrating the legal right to participate in the management of the entity, rather than simply looking to the label of the ownership interest.

**Page 5-32: IRS Issues Final Regs on Issuance of Partnership Interests in Exchange for Debt (T.D. 9557 11/15/2011)**

IRC sec 108(e)(8) provides that if a debtor partnership transfers a capital or profits interest in that partnership to a creditor in satisfaction of its recourse or non-recourse debt, the partnership is treated as having satisfied the debt with an amount of money equal to the fair market value of the partnership interest, for purposes of determining whether the partnership has any cancellation of debt (COD) income. Thus, if the FMV of the partnership interest transferred to the creditor is no less than the debt cancelled in the exchange, the partnership has no COD income.

The code section further provides that if the FMV of the partnership interest is less than the amount of the debt, the resulting COD income that is included in the distributive shares of taxpayers which were the partners in the partnership immediately before the discharge.

**Example:** Partnership MLC, which consists of three equal partners Moe, Larry, and Curley, owes a debt of \$100,000. It discharges the debt by transferring to the creditor a partnership interest that has a fair market value of \$70,000. The partnership is treated as having satisfied the debt with \$70,000 of cash, and thus has COD income of \$30,000 (\$100,000 – \$70,000). Therefore, \$10,000 is included in the distributive shares of each partner--Moe, Larry, and Curley.

**Fair Market Value of Partnership Interest:** While this rule is simple to state, an obvious difficulty in applying it is determining the FMV of the partnership interest transferred to the creditor. The final regulations (*sec. 1.108-8(a)*) allow the transferred interest to be valued using the **liquidation value** of the partnership, if all of the parties (including the partners) to the exchange use the liquidation value to determine all the tax consequences of the exchange, and:

- 1) The terms of the exchange are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and
- 2) Subsequent to the exchange, the transferred partnership interest is not reacquired by the partnership or a related party as part of a plan to avoid the recognition of COD income.

Under this safe harbor, the liquidation value of a transferred partnership interest equals the **amount of cash that the creditor would receive** with respect to the interest if, immediately after the debt-for-equity exchange, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the FMV of those assets and then liquidated.

If a debtor partnership holds an interest in another partnership, that partnership interest is also valued using the liquidation value for this purpose.

**Treatment of Creditor Receiving Partnership Interest:** If the FMV of the partnership interest received by the creditor is less than the amount owed on the exchanged debt, then the creditor is realizing a bad debt loss equal in amount to the COD income realized by the partnership. However, the final regulations do not allow the creditor to recognize that bad debt loss. The creditor is not only a lender in the transaction, but also an incoming partner. And IRC sec. 721 provides that an incoming partner contributing an asset to a partnership in exchange for a partnership interest does not recognize any gain or loss on the contribution. The final regulations (*sec. 1.721-1(d)(1)*) dictate that the sec. 721 nonrecognition rule governs the treatment of both the debtor partnership and creditor in a debt-for-equity exchange.

The significance of sec. 721 treatment *to the partnership* is that the transfer of the partnership interest to the creditor is not treated as satisfaction of the debt by way of a transfer of a fractional interest in each asset of the partnership to the creditor. Potentially, if sec. 721 did not apply, the partnership would recognize gain or loss equal to the excess of the FMV of each partial asset deemed transferred to the lender over the partnership's adjusted basis in that partial asset.

**Basis to Creditor:** Under sec. 722, the creditor will take a basis in the partnership interest received in the exchange equal to the creditor's basis in the canceled debt. Therefore, if the FMV of the interest received is less than the amount of basis of the debt canceled, the creditor will end up with a basis in its partnership interest that is higher than the FMV of the partnership interest received. In other words, the loss not recognized on the debt-for-equity exchange gets built into the creditor's partnership interest. The creditor's holding period for the debt would also tack onto the holding period of the partnership interest, under sec. 1223(1). So the creditor will ultimately recognize the loss (i.e., a capital loss) when it disposes of its partnership interest.

**Treatment of Cancelled Expenses:** Reg. sec. 1.721-1(d)(1) provides that the general nonrecognition rule for the transferring credit does not apply to a debt-for-equity exchange to cancelled partnership debt in the form of *unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness*. Thus, if a debt for such unpaid amounts is cancelled in exchange for a partnership interest, the creditor will recognize a loss to the extent the FMV of the partnership interest is less than the creditor's tax basis in the unpaid expenses receivable.

**Note:** A *cash basis* creditor will have a zero basis in the unpaid expenses, and so will recognize a *gain* on the exchange, equal to the FMV of the partnership interest received, as the sec. 721 nonrecognition rule does not apply.

On the partnership side, if the partnership satisfies a debt for unpaid expenses with a transfer of a partnership interest, it will be treated as having paid those expenses with an amount equal to the FMV of transferred interest. For example, if a partnership owes a landlord \$50,000 for rent, and satisfies the debt by giving the landlord a partnership interest worth \$30,000, the partnership will be treated as having paid the landlord \$30,000.

- If the partnership uses the *accrual method* and has a liability of \$50,000 for rent payable on its books, it will recognize COD income of \$20,000, recapturing \$20,000 of the \$50,000 of rent it previously accrued and deducted but that has now been cancelled.
- If the partnership uses the *cash method*, it will have no liability booked for the rent payable. The partnership will recognize \$30,000 of rent expense upon the transfer of the \$30,000 FMV partnership interest to the landlord.
- Because Sec. 721 nonrecognition does not apply to partnership interests transferred in exchange for the enumerated unpaid expenses, the partnership loses the protection against gain recognition on the deemed transfer of partial assets of the partnership to the creditor, as described above.

However, the regulations preserve this protection, even though sec. 721 does not apply. *Reg. sec. 1.721-1(d)(2)* clarifies that the partnership recognizes no other gain or loss from a deemed exchange of other partnership assets when it transfers the partnership interest in payment of the unpaid expenses.

***Cancellation of Installment Debt:*** The preamble to the final regulations also notes that the nonrecognition rule of sec. 721 does not apply where the lender receives a partnership interest in cancellation of an installment note owed to it by the partnership. The IRS believes that a cancellation of the installment note in this situation should be treated as a disposition of the note under sec. 453B, triggering deferred installment gain. The IRS will be issuing regulations to clarify this issue.

***Cancellation of Debt Owed to an Existing Partner:*** The preamble to the proposed regulations requested comments on whether any special allocation rules of COD income should apply where partnership indebtedness owed to a preexisting partner is satisfied with the transfer of a partnership interest. This situation arguably creates complications due to the fact that lender partner's interest is changing at the time the COD income is generated. The final regulations do not create any special rules for this situation. The IRS noted that existing guidance in Rev. Ruls. 92-97 and 99-43 provide an appropriate framework for determining how COD income should be allocated in various fact patterns, whether or not the creditor is a partner in the partnership.

## **Chapter 7:**

### **Page 7-19: California Enacts New Penalty for Misclassifying Employees**

***SB 459*** (10/9/2011) adds new *sec. 226.8* to the *California Labor Code*, giving the California Labor Commissioner the authority to assess stiff penalties on employers who misclassify workers as independent contractors. Employers who are found to have “willfully” misclassified a worker as an independent contractor will be subject to a fine of not less than \$5,000 nor more than \$15,000, for each violation. If it is determined that the employer has engaged in a “pattern or practice” of such violations, the penalty is from \$10,000 to \$25,000 per violation. Moreover, the employer will have to “display prominently” on its internet website a notice of its violation and information about where workers can file complaints if they believe they have been misclassified as independent contractors by the company.

***Note:*** This is not a penalty that will be administered by the EDD. The California Labor Commissioner is the head of the Division of Labor Standards Enforcement, which is part of the Department of Industrial Relations.

***Advisor Liability:*** The new law also adds *sec. 2753* to the Labor Code, which provides: “A person who, for money or other valuable consideration, knowingly advises an employer to treat an individual as an independent contractor to avoid employee status for that individual shall be *jointly and severally liable* with the employer if the individual is found not to be an independent contractor.”

Attorneys, but not CPAs, are exempted from this liability. Obviously, this penalty exposure dictates added caution in advising clients on worker classification matters.

**Chapter 8:**

**Page 8-28: District Court Grants IRS Motion to Force BOE to Release Gift Records**

Federal district court judge Morrison England has granted the IRS' resubmitted petition *In the Matter of Tax Liabilities of John Does (ED Cal 12/15/2011)*, seeking to summons property tax information from the California State Board of Equalization related to parent-child and grandparent-child transfers of real estate. The IRS sought this information in order to pursue potential unreported gift tax liabilities on these transfers.