Repair & Maintenance Expense

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Topics for Discussion

- Overview of Repair & Maintenance Expense
- Repair & Maintenance Expense: Opportunities
- Repair & Maintenance Expense: Tax Law
- Repair Expenditures: Examples
- Repairs: Accounting Method Changes
- Repair & Maintenance Expense: IRS Initiatives
- Final Thoughts

Overview of Repair & Maintenance Expense

- Companies often follow their financial statement treatment of incidental repairs & maintenance expenses.
- The Company's policy often results in capitalization of costs for financial statement purposes.
- The tax method for repairs usually follows the method used for financial statement purposes.
- The use of Federal tax principles often can result in many expenditures being deductible.

Overview of Repair & Maintenance Expense

- Companies may deduct for Federal tax purposes expenditures for repairs that "keep" property in useful condition.
- For Federal tax purposes, companies are required to capitalize expenditures that:
  - Appreciably extends the useful life of a unit of property ("UOP");
  - Materially increases the value of the UOP; or
  - Adapts the UOP to a new or different use.

Repair & Maintenance Expense: Opportunity

- Companies have significant opportunities to determine whether otherwise deductible repair costs have been improperly capitalized and depreciated for tax purposes rather than deducted currently.
- Applicable to companies in many capital intensive industries:
  - Retail
  - Banking
  - Hospitality
  - Oil & Gas Exploration and Production
  - Pipeline Transportation
  - Telecommunications
  - Utilities
- To deduct prior capitalized costs, an accounting method change must be filed.

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Repair & Maintenance Expense: Opportunity

- Companies filed advanced consent method (non-automatic) change in method of accounting for their 2008 tax year
- IRS Rev Proc 2009-39 allows for an automatic method change
- Present Method of Accounting
  - Capitalize certain incidental repairs and maintenance costs
  - Depreciate costs over a period of 5 to 39 years.
- Proposed Method of Accounting
  - Properly treat costs as ordinary and necessary business expenses for incidental repairs under Treas. Reg. Sec.1.162-4

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Repair & Maintenance Expense: Tax Law

Current Law

- IRC Sec. 162 and Treas. Reg. Sec. 1.162-4
- IRC Sec. 263(a) and Treas. Reg. Sec. 1.263(a)-1
- Unit of Property (“UOP”)
- Three-part Test
  - Materially add to the value of property,
  - Appreciably prolong the life of the property, or
  - Adapt property for a new or different use
- Plan of Rehabilitation and IRC Sec. 263A

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Repair & Maintenance Expense: Tax Law

Proposed Law

- Proposed Treasury Reg. Sec. 1.162-4 and 1.263(a)-3
  - Unit of Property
  - Routine Repair & Maintenance Safe Harbor
  - Three- part Test
    - Betterment of the property
    - Restore the unit of property
    - Adapt property to a new or different use

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Repair Expenditures

Building and Structural Components

- UOP is the building and its structural components
  - Examples of repair expenditures include:
    - HVACs- Replacement of HVAC unit and its component parts
    - Roof Repairs- Patching leaks, relaying of tar, removal of old layers, adding layer of shingles over existing, replacement of sectional units
    - Remodels and Refreshing Costs- Interior and exterior remodels to maintain quality standards
    - Other Building Repairs and Replacements- Floor and ceiling tiles, windows, doors, wiring, plumbing

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Repair Expenditures

Furniture and Fixtures

- UOP is each individual piece of furniture or fixture (e.g. chairs, tables, cabinets, booths, counter tops, lighting)
  - Examples of repair expenditures include:
    - Disassembly, cleaning and reassembly
    - Refinishing
    - Repainting
    - Resurfacing
    - Replacement of components (e.g. cabinet door, chair leg)

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Repair Expenditures

Land Improvements

- UOP is each type of contiguous land improvement (e.g. parking lots, sidewalks, landscaping)
  - Examples of repair expenditures include:
    - Filling
    - Patching
    - Repaving
    - Resurfacing
    - Replacing components (e.g. plants, parking curbs)

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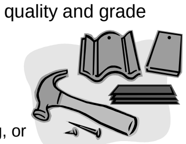
Repair Expenditures: Examples

Example 1

- The owner of a convenience store replaces damaged shingles on a section of the roof with new shingles of a similar quality and grade
- The owner treats the building as the UOP
- The expenditures do not:
  - Materially add value to the building
  - Appreciable extends the useful life of the building, or
  - Adapts the building to a new or different use
  - For tax purposes:
  - The expenditures are Deductible Repairs



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Repair Expenditures: Examples

Example 2

- The owner of a restaurant has damaged clay shingles on large portion of their roof and replaces all the shingles on the roof with new metal shingles.
- The owner treats the building as the UOP
- The expenditures:
  - Materially add value to the building
  - Appreciable extend the useful life of the building- maybe
  - For tax purposes:
  - The expenditures are Not deductible repairs. The expenditures should be Capitalized and Depreciated.

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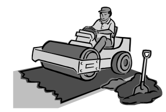
Repair Expenditures: Examples

Example 3

- Retail shopping center owner resurfaces an existing surface parking lot with a 1" overlay.
- The taxpayer treats the parking lot as the UOP
- The expenditures do not:
  - Materially add value to the parking lot
  - Appreciable extend the useful life of the parking lot
  - For tax purposes:
  - The expenditures are Deductible Repairs.



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Repairs: Accounting Method Changes

Rev. Proc. 2009-39

- Updates and modifies Rev. Proc. 2008-52
- Includes new procedural rules, adds new automatic method changes, modifies prior automatic method changes
- Permits repairs method changes to be filed automatically
- Separates repairs method changes into two separate Form 3115:
  - Repairs
  - Retirements

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Repairs: Accounting Method Changes

Rev. Proc. 2008-52

- New automatic repairs change in Sec. 3.06 of Appendix
  - IRC Sec. 481(a) Adjustment
  - No ruling on UOP
  - Required to attach statement to Form 3115 with specific representations
- Now new Sec. 6.24 and 6.25 of the Appendix
  - Require to attach statement to Form 3115
  - Must provide detailed descriptions of property, determination of UOP for acquisitions and dispositions, and legal authority if UOP is inconsistent
  - Must file a third copy of Form 3115 with IRS in Ogden, UT

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Repairs: Accounting Method Changes

Rev. Proc. 2008-52 (cont'd)

- Required representations that costs:
  - Are incurred to keep property in ordinarily efficient operating condition;
  - Do not materially increase value or substantially extend useful life of property before the particular event or wear and tear that led to the repairs expenditure;
  - Do not adapt any UOP to new or different use;
  - Do not include cost to replace any UOP or any major component;
  - Are not incurred as part of plan of rehabilitation, or improvement to any UOP; and
  - Do not result from any prior owner's use of any UOP.

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Repair & Maintenance Expense: IRS Initiatives

- LMSB Emerging Issues Memorandum
  - Issued to LMSB examiners in May 2009 and publicly in September 2009
  - Advises examiners of:
    - Significant increase in repairs method changes since mid 2008
    - Substantial IRC Sec 481(a) adjustments
  - Reminder that proposed regs have not been finalized
- Industry Director Directives Issued in Jan. 2010
  - IDD #1 elevates the repairs method changes to Tier I issue
  - IDD #2 provides guidance to IRS field agents on use of National Office resources in examinations of repairs method changes

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Repair & Maintenance Expense: Final Thoughts

- Finalization of Re-proposed Regs anticipated by end of 2010.
- Taxpayers that have made repair method changes should:
  - Assess if positions taken are inconsistent with authoritative guidance or not sufficiently documented in light of new IRS directives
  - Take corrective action to prepare to respond to information requests and defend their positions on IRS exam.
- If proposed regs are not finalized for 2010, taxpayers that have not done so already, should consider whether to change method of accounting for repairs and maintenance expenditures and have a quality study performed.

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Questions

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Thank you!

Please feel free to contact us with any questions.

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REPAIR AND MAINTENANCE EXPENSE DEDUCTIONS

By Richard Schneider, Rick Happel, and Brian Balish of SC&H Group

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INTRODUCTION

The difference between deductible costs and capital expenditures can mean thousands of dollars to property owners who perform regular maintenance and repairs. Recently proposed tax regulations and IRS revenue procedures are prompting taxpayers to assess their own treatment of such expenditures, since often times taxpayers were following their GAAP treatment of capitalizing such items. The revenue procedures allow taxpayers to make an automatic change in their accounting method for tax purposes to address the proper treatment of such expenditures not only for the current year, but also for past tax years, creating an opportunity for significant current year savings.

The following outline provides a historical perspective of the tax law regarding the deductibility of repair and maintenance expenses, and other issues leading to the recent proposed regulations under IRC Sections162 and 263 and other current developments.

SEMINAL COURT CASES

The following three seminal cases address the deductibility of repair and maintenance expenses, including the three part test in the regulations under § 1.162-4. The decision in *Ingram Industries, Inc*. also provides a case of first impression on what the unit of property is for purposes of determining whether expenditures are repair and maintenance expenses versus capitalized improvements to property.

I. ILLINOIS MERCHANTS TRUST CO., EXECUTOR., 4 BTA 103 (1926)

a. Background & Findings of Fact

i. In 1919 the water level in the Chicago River suddenly and unexpectedly receded and thus exposed part of the foundation piles under the taxpayer's building.

ii. These piles immediately started to rot, which caused the wall on the river side to settle to such extent that the collapse of the building threatened.

iii. The seven-story brick building owned by the taxpayer was located on the west bank of the south branch of the Chicago River which rested on a so-called "floating foundation" of wooden piles.

iv. To prevent its total loss and to arrest further damage to the structure, it was necessary to saw off the rotted piles at a point below the new water level and to insert concrete supports between the ends of the submerged piles and the floor of the building. This work required the removal of a large portion of the ground floor. It was also necessary to shore up and raise, so far as possible, the partially collapsed wall.

v. The work done did not prolong the original estimated life of the building, nor did it increase its value.

b. Opinion

i. The taxpayer claimed the expenditures were deductible, under Section 214 (a) (1) of the Revenue Act of 1918 (predecessor to current Section 162) as ordinary and necessary expenses of carrying on business.

ii. The Commissioner contended that the expenditures were capital expenditures and therefore not deductible.

iii. In support of their contrary contentions both parties relied on Article 103 of Regulations 45. However, the taxpayer was emphasizing the rule covered in the first sentence “The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures.” Whereas the Commissioner was emphasizing the second sentence, “ Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property should be charged against the depreciation reserve.”

iv. The Court addressed the following issues as they relate to the expenditures under Article 103 of Regulations 45:

1. Does the expenditure substantially prolong the useful life of the property?
2. Does the expenditure materially increase the value of the property?
3. Does the expenditure adapt the property to a new or different use?

v. The Court ruled that the expenditures did not substantially prolong the "probable, normal, useful" life of the property, did not increase the value of the property and did not adapt the property to a new or different use and were therefore deductible under Section 214(a)(1) of the Revenue Act of 1918.

II. PLAINFIELD-UNION WATER CO., 39 TC 333, (1962)

a. Background & Findings of Fact

i. Business expense deduction granted to the water company for costs incurred in cleaning out and lining with cement its tar-painted, cast-iron water pipes.

ii. The useful life of the main was not increased by the lining and cleaning and neither its strength nor capacity was enhanced.

iii. The expenditure did not enable taxpayer to put the pipes to a new use. The cement lining was not a permanent addition to the pipe.

iv. By lining the pipes taxpayer merely eliminated, temporarily, a maintenance problem. In addition the cleaning and cement lining comprised a minor part of taxpayer's operation and was not part of any general plan.

b. Opinion

i. The issue is whether the cost of cleaning and cement lining the main during 1957 is a deductible repair under Sec. 162(a) and the regulations thereunder, or whether it is a capital expenditure.

ii. The Court reaffirmed the three-part test cited in *Illinois Merchants Trust Co*. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

iii. The Court ruled that the useful life, strength, value, and capacity of the cleaned and lined water pipes were not increased by the expenditure in issue and did not make the relevant water main suitable for any new or additional use. The main continued to be used in the normal course of petitioner's operations as a water company. Therefore, the cleaning and cement lining of the main in 1957 was a repair and deductible under Sec. 162(a).

III. INGRAM INDUSTRIES INC. ET AL. V. COMMISSIONER, TC MEMO 2000-323 , (2000)

a. Background & Findings of Fact

i. Barge transport business's costs of towboat engine cleaning and inspection were currently deductible, not capital expenses.

ii. Procedures, including power pack and other unit removals and parts inspection, were for regular maintenance, not complete overhaul where engines were considered part of, not separate from boats; and procedures didn't appreciably prolong boats' life, but were more in nature of preventative maintenance allowing engines to operate over the intended 40-year useful life of the engines and the towboats.

iii. Procedures involved few replacements and relatively low costs as compared to those necessary in overhauls; were performed in comparably short time while boats were still serviceable as compared to overhauls which took up to 5 months and required the engine to be removed from the boat.

iv. Procedures clearly didn't adapt property for new use or materially add to its value even if considering relatively low total cost..

b. Opinion

i. The issue is whether taxpayer's expenditures for the described procedures were expenses deductible under § 162(a) or whether they should have been capitalized under section § (a). Expenses incurred for regular maintenance to keep property in an ordinarily efficient operating condition are currently deductible.

ii. The Court had to determine whether the expenditures were routine maintenance or an overhaul. The Court found it significant that the taxpayer performed the procedures at a time when the engines were completely serviceable and the purpose of performing the procedures was to keep the towboat engines in good operating condition. This is in contrast to the cases relied on by respondent where the property was not serviceable and had to be replaced or completely rebuilt or overhauled. Generally, in the cases relied on by respondent, the taxpayer allowed the asset to completely deteriorate and then rebuilt it resulting in a clearly defined new useful life.

iii. The Court cited the standards expressed in *Plainfield-Union Water Co*. as follows: An expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair. A capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property.

iv. In order to be entitled to a deduction for an overhaul, taxpayer must clearly show that it is an incidental repair that does not appreciably prolong the property's useful life, but keeps it in an ordinarily efficient operating condition.

v. The Court ruled that the maintenance procedures did not constitute an overhaul, but rather were of the nature of routine maintenance that did not materially add to the value of the towboat, that such maintenance kept the engines and towboat in efficient operating condition, and did not adapt the engines or the boat to a new or different use or extend their useful life. Therefore, the taxpayer was entitled to deduct the cost of maintaining its towboat engines under Sec. 162.

OTHER RELEVANT COURT CASES

The following cases provide further support and clarification of the 3 part test developed in *Illinois Merchants Trust Co.* and the other cases above and support the fact that expenditures that keep property in their routine operating condition and that do not increase life expectancy, value or use are deductible as repair and maintenance expenses under Sec. 162.

I. Midland Empire Packing Co., 14 T.C. 635 (1950)

a. The continued operation of a meat packing plant was threatened by oil seepage from a neighboring refinery into the cellar of the plant. Taxpayer lined the basement walls and floors with concrete to restore normal operating condition.

b. The Court held that the expenditure was a deductible expense, since it did not increase useful life or value to taxpayer, did not provide for changed or enlarged use of the premises, and did not materially add value when compared with the pre-seepage period.

c. "The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used."

II. Kansas City Southern Ry. Co. v. United States, 112 F. Supp. 164 (Ct. Cl.) (1953)

a. The taxpayer expended over $116,000 to eliminate the effects of water pockets which had formed under portions of its railroad track. The elimination was accomplished by power-driving wooden poles vertically into the ground at the ends of the railroad ties, a process having beneficial effect for approximately 15 years.

b. Failure to correct the water pocket effects would not have caused a shutdown of the line, but would have made operation at full capacity impossible.

c. The court allowed the deduction and stated that the railroad track, after the poles were driven, was still just a railroad track, and the parts of it where the poles were driven were no more useful than the other parts which had not needed this work.

REPAIR AND MAINTENANCE EXPENSE DEDUCTIONS

III. J. H. Collingwood, 20 T.C. 937 (1953)

a. An ordinary business expense deduction was allowed for the cost of farm-land terracing.

b. The need for the expenditure arose from a soil erosion situation which had been occurring for some time.

c. The Court held that the purpose of the expenditure was to maintain the farm in an ordinary efficient condition.

d. The deduction was allowed even though the soil erosion was not at all the unusual, unexpected, or sudden factor.

IV. Regenstein v. Edwards, 121 F. Supp. 952 (M.D. Ga.) (1954)

a. The floor of the third story of landlord's building sagged. After some temporary steps, steel columns and steel crossbeams were installed in order to permanently cure the defect.

b. The court held that the entire expenditure was for the sole purpose of restoring the property to its former condition and allowed the deduction since neither use, value, nor life expectancy was increased.

WHAT IS THE UNIT OF PROPERTY FOR PURPOSES OF DETERMINING REPAIR AND MAINTENANCE EXPENSES?

The next cases, which were decided in favor of the taxpayers, are pivotal in that they provide the factors to apply in determining what the unit of property is for determining the deductibility of expenditures under the three part test for routine repairs and maintenance.

I. Smith V. Commissioner, 300 F3d 1023, 1030 [90 AFTR 2d 2002-5747] (9th Cir., 2002)

a. Background & Findings of Facts:

i. Involved the deductibility of the taxpayer's process of relining its aluminum-producing cells as part of the taxpayer's aluminum production operation.

ii. The smelting operation could continue with missing cells because the cells were arranged so that the electrical current could bypass a particular cell when necessary.

iii. The taxpayer required a minimum of functioning cells to operate its cell line on a sustained basis.

b. Opinion

i. The Court had concluded that, although the taxpayer had not set up its line to make this possible, the individual cell had the capability of producing aluminum and was sufficiently free-standing to constitute a separate unit of property.

ii. The Court not only rejected the cell line as the unit of property, but also rejected the assertion that the cell lining was the relevant unit of property, presumably because the cell lining was not capable of producing aluminum without the cell.

II. FEDEX CORPORATION V. U.S., Cite as 92 AFTR 2d 2003-5986 (291 F. Supp. 2d 699), (2003)

a. Background & Findings of Fact

i. At issue was the deductibility as a repair for the air freight carrier's cost of off-wing engine shop visits (ESVs).

ii. As part of its business, FedEx operates a fleet of aircraft which are powered by jet aircraft engines, and auxiliary power units ("APUs") that require off-aircraft inspection, heavy maintenance, and repair of jet aircraft engines and APUs which were conducted by third-party vendors during ESVs.

iii. As required by Federal Aviation Regulations ("FARs"), FedEx's aircraft could not operate without three mounted serviceable jet engines installed at all times. When FedEx removed one of the three engines from the wing to send it to an engine shop for an ESV, FedEx replaced the engine with another used FedEx engine that had returned from an ESV.

iv. Aircraft engine ESVs, occurred usually based on engine use, measured in hours since last shop visit or cycles since last shop visit, or because an engine required immediate service in order to comply with FAA requirements. APU ESVs generally took place as needed.

v. Jet aircraft engines and APUs operated by FedEx for the periods in question were acquired or leased by FedEx as installed components of completely assembled aircraft or as spares in connection with the acquisition of completely assembled aircraft, as was the case for the other carriers within the entire airline industry. Another common practice within the entire airline industry, as was the case for FedEx, was appraisals of jet aircraft engines and APUs being performed in conjunction with "full appraisals"—the appraisals of completely-assembled aircraft—rather than isolated appraisals of aircraft components.

vi. The economic useful life of the airframes and aircraft engines operated by FedEx, and defined by the International Society of Transport Aircraft Trading ("ISTAT") exceeded thirty (30) years. To attain this expected useful life, airframes and jet aircraft engines and APUs were anticipated to undergo periodic maintenance and repairs, including off-wing maintenance of the engines.

vii. The relative cost of ESVs varied from 0.2% to 0.8% of aircraft value for APUs and 0.9% to 8.1% of aircraft value for engines.

b. Opinion

i. The United States suggested that an ESV is a repair of the engine or APU while FedEx contended that an ESV is a repair of the aircraft powered by the engine or APU.

ii. The Court citing *Ingram* and *Smith*, said taken together, these cases indicate the factors a court should consider in identifying the appropriate unit of property to which to apply the Repair Regulations. First, the court should consider whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management, or accounting purposes. Second, the court should determine whether the economic useful life of the component part is coextensive with the economic useful life of the larger unit of property. Third, the court should determine whether the larger unit of property and the smaller unit of property can function without each other. Finally, the court should weigh whether the component part can be and is maintained while affixed to the larger unit of property.

iii. In finding for the taxpayer, the Court determined under the first factor that the industry practice was to buy and treat components as integrated parts of whole aircraft.

iv. In considering the second factor, the Court determined using the approach in *Ingram*, that the useful life of the engine was coextensive with the life of the aircraft that it powers since the engine was not "regularly and periodically" replaced over the life of the aircraft.

v. The Court considered for the third factor of whether the larger unit of property and the smaller unit of property can function without each other that, like in Ingram, engines and APUs cannot perform their function of powering jet aircraft unless they are mounted on those aircraft in proper working order and aircraft cannot fly without engines and APUs.

vi. For the fourth factor, the Court considered whether the smaller unit of property must be removed from the larger unit of property for maintenance to occur. As cited in Ingram, the court concluded that the towboat was the unit of property in part because the towboat engines were maintained while attached to the towboat. However, in finding for the taxpayer in treating the aircraft as the unit of property, the Court found the fact that components were removed from aircraft during service wasn't in itself dispositive.

vii. Thus, the Court ultimately held that FedEx's engines and APUs were so closely linked to the aircraft on which they were mounted that they were part of a single unit of property, the aircraft, for purposes of the Repair Regulations. Thus, the ESV costs were deductible as ordinary and necessary business expenses incidental to the maintenance of FedEx's aircraft, engines, and APUs.

IRS AND TREASURY RESPONSE TO FEDEX CORPORATION DECISION

I. As a result of the IRS' loss in *FedEx Corporation v. U.S.*, the Service issued Notice 2004-6, IRB 2004-3, 1/20/2004.

a. The Notice states that the Service and Treasury Department intend to propose regulations that clarify the application of IRC §§ 162 and 263 to expenditures paid or incurred to repair, improve, or rehabilitate tangible property.

b. The Notice identifies issues the Service and Treasury Department may address in the regulations. The Service and Treasury Department want to provide clear, consistent and administrable rules that will reduce the uncertainty and controversy in this area, while also preventing the distortion of income.

c. The Service and Treasury Department requested public comments on whether these or other issues should be addressed in the regulations and, if so, what specific rules and principles should be provided.

d. The Service and Treasury Department requested comments on 15 different issues. Such issues included the following:

i. What general principles of capitalization should apply to expenditures to repair or improve tangible property?

ii. In applying the general principles, what is the appropriate "unit of property"?

iii. In determining whether an expenditure materially increases the value of property or substantially prolongs the useful life of property, what is the proper starting point for comparison?

iv. What is "value" for purposes of the "material increase in value" rule?

v. How should it be determined whether there has been a “material increase” in value?

vi. What is “useful life” for purposes of the “substantially prolongs useful life” rule?

vii. How should it be determined whether an expenditure “substantially prolongs” the useful life of the property?

viii. What factors are relevant in determining whether an expenditure adapts property to a new or different use?

II. Treasury Issues Proposed Regulations On Capitalization of Improvements to Property under IRC Section 263

a. In August of 2006, the Service issued proposed regulations § 1.263(a)-3 to provide an overall framework that expands the standards in the current regulations by drawing on principles developed through case law. Specifically, the proposed regulations provided:

i. Exclusive factors for determining whether amounts paid to restore property to its former working condition must be capitalized as an improvement.

ii. Guidance concerning the economic useful life of a unit of property and activities that substantially prolong the economic useful life.

iii. Rules for determining the appropriate unit of property to which the rules should be applied.

iv. Several safe harbors and simplifying assumptions to reduce the administrative and compliance costs associated with this section of the tax code.

b. Although these initial proposed regulations did not provide a de minimis rule in which small cost items were exempt from capitalization, the preamble solicited comments on whether such a rule should be adopted in final regulations.

III. Treasury Issues Re-proposed Regulation under IRC Sec. 263

a. In March of 2008 the Treasury issued re-proposed regulations under § 1.263 (a) – 3 in response to comments received from initial set of proposed regulations.

b. The initial proposed regulations defined a unit of property as "improved" if the costs paid materially increase the value of the unit of property or restore the unit of property. This treatment was criticized for not drawing enough of a bright line test.

c. The new proposed regulations attempt to address that criticism by establishing a new "betterment" standard for determining if there has been a material increase in value.

d. Under the new proposed regulations, taxpayers must capitalize amounts spent that:

1. Result in a betterment to a unit of property;

2. Restore a unit of property; or

3. Adapt a unit of property to a new or different use.

e. The new proposed regulations also provide definitions of “betterment” and “restoration.”

i. An expenditure results in a "betterment" if the expenditure:

1. Ameliorates a material condition or defect that existed prior to the acquisition of the property or arose during the production of the property,

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

ii. Six bright-line rules provide an expenditure is a "restoration" to the unit of property if the expenditure:

1. Is for the replacement of a component of the unit of property for which the taxpayer had taken a loss deduction (except for casualty losses);
2. Is for the replacement of a component of a unit of property and the taxpayer had taken into account the adjusted basis of the component in realizing gain or loss resulting from a sale or exchange of the component;
3. Is for repair of damage to a unit of property for which the taxpayer has taken a basis adjustment as a result of a casualty loss;
4. Returns the property to ordinary efficient operating function if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;
5. Results in the rebuilding of the property to a "like-new" condition after the end of its economically useful life, or;
6. Is for the replacement of a major component or a substantial structural part of the unit of property (defined as 50% or more of the cost or physical structure of the unit of property).

f. The new proposed regulations also provide guidance on what is the proper unit of property to which to apply the "betterment or restoration" factors. The new unit-of-property rules are generally based on a "functional interdependence" standard, similar to that used for depreciation and Sec. 263A purposes

g. The proposed regulations also provide a $100 de minimis rule under which certain small cost items can be deducted, and they provide a safe harbor for certain routine maintenance expenses less than or equal to 0.1% of the taxpayer's gross receipts for the taxable year or 2% of the taxpayer's total depreciation and amortization expense as reported on the taxpayer's financial statements for the taxable year.

IV. Further Developments Regarding Accounting Method Changes Following Re-Proposed Regulations

a. With the fear that when the re-proposed regulations were finalized, taxpayers would be precluded from making adjustments to correct improper accounting method for repair expenditures that were capitalized in prior years rather than expensed, many taxpayers filed non-automatic accounting method changes, Form 3115, under Rev Proc 2008-52.

b. IRS Updates Accounting Method Changes for Repair and Maintenance Expenses to Automatic Change

i. Revenue Procedure 2009-39 provides certain additions, modifications and clarifications to Revenue Procedures 2008-52 and 97-27, including making repair method changes an automatic change.

ii. A taxpayer may change its method of accounting from capitalizing costs paid or incurred to repair and maintain tangible property (including network assets) to treating the repair and maintenance costs as ordinary and necessary business expenses under IRC § 162 and Treas. Reg. § 1.162-4.

iii. Rev Proc 2009-39 separates that the repairs method changes into two separate Form 3115s:

a. One for the repairs expenditures, resulting in a negative Sec. 481(a) adjustment taken in year of change.

b. Another for the retirements, resulting in a positive Sec. 481(a) adjustment to be taken over 4 years.

iv. The method change also applies to a taxpayer that wants to change the unit of property it uses to determine the deductibility of repair and maintenance costs to a unit of property that is permissible under applicable legal authority.

v. The taxpayer must provide representation statements attached to the Form 3115 that costs at issue:

a. Are incurred to keep property in ordinarily efficient operating condition;

b. Do not materially increase value or substantially extend useful life of property before the particular event or wear and tear that led to the repairs expenditure;

c. Do not adapt any UOP to new or different use;

d. Do not include cost to replace any UOP or any major component;

e. Are not incurred as part of plan of rehabilitation, or improvement to any UOP; and

f. Do not result from any prior owner's use of any UOP

vi. The taxpayer must also attach a statement to the Form 3115 that provides detailed description of property, determination of unit of property for acquisitions and dispositions, and legal authority if the unit of property is inconsistent with authoritative guidance.

vii. Taxpayer must file a third copy of Form 3115 with IRS in Ogden, UT.

viii. A taxpayer may not change its method of accounting in reliance upon the rules contained in the proposed regulations related to the capitalization of expenditures related to tangible property, but should not take positions in conflict with such regs.

ix. An accounting method change for property (including expenditures) subject to a repair allowance election under Treas. Reg. § 1.167(a)-11(d)(2) is excluded from the automatic accounting method change.

c. The Service issues guidance and designates repairs and maintenance costs accounting method change as Tier I issue.

i. In September of 2009, The Service released a Large and Mid-Size Business (LMSB) emerging issue memorandum LMSB-04-0509-019:

1. The memorandum provided notification of an "emerging issue" affecting all industries relating to the recharacterization of costs associated with tangible assets, previously capitalized under IRC section 263(a), which are being treated as currently deductible repairs under IRC section 162.

2. This current treatment resulted from a significant increase in filings of Forms 3115 since mid-December 2008. The issue of the memorandum related to an "expansive change" in the designation of the "Unit of Property".

3. The memorandum noted that examination teams "will be required to analyze the details" of section 481(a) adjustment to determine whether the expenditures or a portion thereof are deductible under current law.

ii. In January of 2010, The Service issued two industry director directives (IDDs) relating to situations in which a taxpayer changes its method of accounting for costs previously capitalized under Sec. 263(a) as deductible repairs and maintenance under Sec. 162.

1. IDD No. 1 elevates repairs method changes to a Tier I issue for IRS examination purposes, as was anticipated by tax professionals after the release of LMSB-04-0509-019.
    a. Tier I issues are of high strategic importance to LMSB and have significant effect on one or more industries. Tier I issues may include areas involving a large number of taxpayers, significant dollar risk, substantial compliance risk or high visibility, when there are established legal positions and/or LMSB direction.
    b. Tier I issue does not trigger an audit although a Tier I issue will be examined and the final determination will be made by the National Office and not by the examining agent.
2. IDD No. 2, issued concurrently with IDD No. 1, provides guidance to IRS field agents to effectively utilize resources in the examination of a taxpayer that changes its method of accounting to re-characterize previously capitalized costs as deductible repairs and maintenance expenses under Sec. 162.

CONCLUSIONS

I. There has been a long standing set of case law providing guidance to taxpayers on how to interpret and apply Treasury regulations under § 1.162-4, for more than 50 years. The more recent cases also help identify the analysis in determining what the appropriate unit of property is for assessing when costs are deductible repairs versus a capitalized improvement to property.

II. The IRS and Treasury's actions in the past few years to provide clarity and ease of administrating the tax laws in this area have created an urgency for taxpayers to apply the rules and law that has existed to their situation in a more favorable light given the Court's holding in *FedEx Corporation* before the proposed regulations become final.

III. The re-proposed regulations under §§ 1.162-4 and 1.263(a) -3, provide helpful guidance and seem to embody many elements that have existed in case law, as well as providing some safe harbor for expensing items that are immaterial in cost. It will be interesting how these proposed rules will be implemented once finalized, potentially using a cut off method for costs incurred by taxpayers going forward.

IV. The additional scrutiny that the IRS applies in their examination of method changes as part of its Tier I initiative may also shed light on how they intend to address repair expenditures going forward, though the proposed regulations are not to be taken into account.

V. If the proposed regulations are not finalized for 2010, taxpayers who have not otherwise assessed and/or made changes in their method of accounting for repair and maintenance expenditures, should consider doing so by conducting a repair and maintenance expense study and filing a

Form 3115 for Accounting Method Change by the due date or extended due date of their 2010 tax return.

Note:

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