



IRS

# IRS ISSUES NEW REGULATIONS

## DEDUCTION AND CAPITALIZATION OF EXPENDITURES RELATED TO TANGIBLE PROPERTY

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### Introduction

In December, 2011, the IRS and Department of Treasury issued proposed and temporary regulations that provide guidance regarding deduction and capitalization of expenditures related to tangible property. The regulations were issued in both proposed and temporary status to allow for public comments on the proposed regulations while the temporary nature of the new regulations allows taxpayers and the IRS to rely on the regulations for tax years beginning on or after January 1, 2012.

The provisions of the regulations are broad and this document does not address all of the provisions. We will provide an overview of the document only and recommend that dealers consult their tax advisor for a complete analysis of how the new regulations may affect dealership activities.

The regulations include modification to several sections of the Internal Revenue Code (IRC) including, but not limited to, §§162, 263(a), and 168 and are intended to clarify and expand the standards in the current regulations and provide certain bright-line tests for applying these standards.

Changes to a taxpayer's treatment of tangible assets based on the new regulations are generally considered to be changes in methods of accounting. Prior to changing any method of accounting, taxpayers must request and receive permission from the IRS. Depending on the type of change, taxpayers may either fall under the advance consent requirements or the automatic change requirements. Each imposes different responsibilities on a taxpayer in order to properly change a method of accounting. We anticipate that there will be further published guidance addressing how a taxpayer can change its method(s) of accounting to comply with the new regulations.

The regulations are not dealership specific and may have a significant affect on many taxpayers. However, one section in particular may be of interest to auto dealerships. Regulation 1.263(a)-3T addresses amounts paid to improve tangible property. While other provisions will undoubtedly affect dealerships, this section is most likely to be of interest to dealers who periodically upgrade, remodel, refresh, or otherwise improve dealership facilities.

**Brief Table of Contents of Regulations Sections (not all inclusive)** The list below is just a portion of the IRC sections that were modified in the new regulations.

- §1.263(a)-1T Capital Expenditures in General
- §1.263(a)-2T Amounts Paid to Acquire or Produce Tangible Property
- §1.263(a)-3T Amounts Paid to Improve Tangible Property
- §1.162-3T Materials and Supplies
- §1.162-4T Repairs

### Overview of Section 1.263(a)-3T – Amounts Paid to Improve Tangible Property

Section 1.263(a)-3T provides a two-step process to determine if property has been improved.

- Step One – What is the unit of property (UOP)?
- Step Two - Did the work performed constitute an improvement to the unit of property?

This two step process is outlined and defined in the new regulations but in fact is the process that taxpayers have always had to engage in when considering improvements to tangible property.

The regulations include UOP rules related to buildings, property other than buildings, and leased property. The scope of this document does not permit a complete discussion of all of the UOP rules. For purposes of this document, we will focus on the building and building systems.

#### **Step One – Determine the Unit of Property**

In general the building *and* its structural components are one UOP, e.g. “the building.” Amounts are treated as paid for an improvement to a building if they:

- (1) improve the building structure **or**
- (2) a building system.

Building systems include the following systems: (not all inclusive – see the regulations for a full list)

- Plumbing,
- HVAC,
- Electrical,
- Fire protection and alarms, and
- Security systems.

#### **Step Two – Apply Improvement Rules (§1.263(a)-3T(d))**

A UOP is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer:

- Result in a betterment to the unit of property (subsection (h)) **or**
- Restore the unit of property (subsection (i)) **or**
- Adapt the unit of property to a new or different use (subsection (j))  
(see the regulations for a full discussion of each item)

If the amounts paid to improve tangible property are determined to be improvements, the taxpayer must capitalize (rather than currently deduct) all of the direct costs of an improvement and all of the indirect costs that directly benefit or are incurred by reason of the improvement.

#### **Conclusion**

Whether or not amounts paid in a store remodel or refresh qualify as an improvement may be a question of degree. The temporary regulations include many examples intended to clarify all of the provisions. Examples relevant to store remodels and refreshes are found in Treas. Reg. 1.263(a)-3T. Examples 6, 7, and 8 discuss the refresh and remodel of a retail store (not a dealership specifically) and include facts intended to clarify when the activities rise to the level of a betterment requiring capitalization. We have included the three examples in the addendum to this Alert.

The regulations related to amounts paid to improve tangible property are complex and each transaction must be analyzed individually. In addition, the regulations contain provisions other than those discussed above that may affect the determination of whether amounts expended in a remodel or refresh result in costs that must be capitalized. If you have any questions regarding the new regulations, we urge you to consult with your tax advisor.



*AUTOMOTIVE ALERT- FEBRUARY, 2012*  
IRS MOTOR VEHICLE TECHNICAL SPECIALIST

DEDUCTION AND CAPITALIZATION OF EXPENDITURES RELATED TO TANGIBLE PROPERTY  
**REGULATIONS EXAMPLES – STORE REMODELS AND REFRESHES**

The preamble to the temporary regulations discusses the treatment of store remodels and refreshes. It concludes that the analysis of whether store refresh or remodel costs result in betterment that would require capitalization rather than deduction requires an examination of all the facts and circumstances.

To provide additional guidance in this area the temporary regulations provide a number of examples that address the refreshing and remodeling of retail buildings. The examples demonstrate a range of outcomes based on the amount and type of work performed on the building and its structural components.

The examples in the temporary regulations illustrate (emphasis added):

- a refresh of retail buildings that merely **keeps the buildings in ordinarily efficient operating condition**;
- a refresh of retail buildings that also **includes an improvement to a building system**; and finally,
- a **large scale refresh and remodel** of retail buildings **that involve an improvement to the buildings**.

**Note:** *the examples below refer to a building “system.” The full definition of a building system can be found in the temporary regulations but can include the following systems (not all inclusive): HVAC, plumbing, electrical, fire protection and alarms, security, and gas.*

Although the examples are not dealership specific, a review of the following examples found in Treas. Reg. 1.263(a)-3T should assist dealers in analyzing the facts and circumstances and determining the proper tax treatment of costs related to tangible property. We recommend that dealers consult their tax advisor for a complete analysis of the regulations and how they relate to dealership activities. *(The emphasis added by bolding and underlining some sections below is for ease of reading only and is not present in the temporary regulations.)*

**Example 6. Not a betterment; building refresh.**

(i) 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. The display tables and the racks all constitute section 1245 property. X pays amounts to refresh 50 stores during the taxable year. In its applicable financial statement, X capitalizes all the costs to refresh the store buildings and amortizes them over a 5-year period. Assume that each section 1245 property within each store is a separate unit of property. Finally, assume that the work does not ameliorate any material conditions or defects that existed when X acquired the store buildings or result in any material additions to the store buildings.

(ii) Under paragraph (e)(2)(ii) of this section, if an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. **Considering the facts and circumstances**, as required under paragraph (h)(3)(i) of this section, 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 under paragraph (h)(1)(iii) of this section. However, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2T(d)(1).

**Example 7. Building refresh; limited improvement.**

Assume the **same facts as Example 6 except, in the course of X's refresh of its stores, X pays amounts to remove and replace the bathroom fixtures** (that is, the 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. Under paragraph (e)(2)(ii) of this section, if any of the amounts paid result in betterments to the building structure or any building system, X must treat the amounts as an improvement to the building. Under paragraph (e)(2)(ii)(B)(2) of this section, **the plumbing system in each of X's store buildings, including the plumbing fixtures, is a building system. 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 each plumbing system** under paragraph (h)(1)(iii) of this section. Under paragraph (f)(3) of this section, X is required to capitalize all the indirect costs that directly benefit or are incurred by reason of the betterment, or improvement, to each 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 under paragraph (f)(3) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, **X must treat the amounts paid for a betterment to each plumbing system as an improvement to X's retail building to which the costs relate, and must capitalize the amounts** under paragraph (d)(1) of this section. However, X is not required under paragraph (f)(3) of this section to capitalize the costs described in Example 6 to refresh the appearance and layout of its stores because those costs do not directly benefit and are not incurred by reason of the improvements to the stores' plumbing systems. Thus, X is not required to capitalize under paragraphs (f)(3) of this section any costs specified in Example 6 for the reconfiguration, cosmetic changes, repairs, and maintenance to the other parts of X's store buildings.

**Example 8. Betterment; building remodel.**

(i) Assume the **same facts as Example 6, 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 performed in Example 6, **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 as defined under (e)(2)(ii)(A). This work includes 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, which are building systems under paragraph (e)(2)(ii)(B)(3) of this section. Specifically, X upgrades 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. The work performed on the buildings' structures and the electrical systems includes the removal and replacement of both section 1250 and section 1245 property. 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.

(ii) Under paragraph (e)(2)(ii) of this section, if any of the amounts paid result in a betterment to the building structure or any building system, X must treat those amounts as an improvement to the building. **Considering the facts and circumstances**, as required under paragraph (h)(3)(i) of this section, 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** under paragraph (h) of this section. **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 under paragraph (h)(1)(iii) of this section. 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 under paragraph (h)(1)(iii) of this section. In addition, the amounts paid for the refresh of the store buildings described in Example 6 must be capitalized** under paragraph (f)(3)(i) of this section because these expenditures directly benefited or were incurred by reason of the improvements to X's store buildings' structures and electrical systems. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the costs of improving the buildings' structures and systems, including the costs to refresh, as improvements to X's retail buildings and must capitalize the amounts paid for these improvements under paragraph (d)(1) of this section. Moreover, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2T(d)(1).