Learning Objectives

After completing this session, participants will be able to perform the following job-related actions:

✔ List the criteria for determining what constitutes an improvement, betterment, restoration, and adaptation under the repair regulations

✔ Define a unit of property under the repair regulations

✔ Describe the effect of the various safe harbors under the repair regulations, and the criteria required to elect them

✔ Prepare a written plan/accounting policy, and understand its applicability to affiliated entities and consolidated groups

✔ Discuss the importance of filing Form 3115, Application for Change in Accounting Method, and the ramifications of the deemed filing under the simplified procedure available to small business taxpayers

✔ Prepare a complete and accurate Form 3115

✔ Discuss the partial disposition rules and describe circumstances when it is appropriate to make the partial disposition election

Introduction

Final regulations provide rules that affect all taxpayers who acquire, produce, or improve tangible property [T.D. 9636, 2013-43 I.R.B. 331]. The rules are generally taxpayer-friendly and provide much-needed clarity to determine whether costs are currently deductible or must be capitalized and depreciated. Some safe harbors simplify the application and implementation of the rules for both small and large business taxpayers.

A common misconception is that the repair regulations do not apply to taxpayers who meet
the exception to filing Form 3115, Application for Change in Accounting Method, under Rev. Proc. 2015-20, 2015-9 I.R.B. 694. However, all taxpayers must follow the repair regulations for years beginning on or after January 1, 2014.

**Observation**  
**Small Business Taxpayers Are Not Exempt**

Rev. Proc. 2015-20 addresses only issues associated with the implementation of the repair regulations for qualifying “small business taxpayers.” The repair regulations have not changed as a result of the issuance of Rev. Proc. 2015-20. All taxpayers must still implement the repair regulations for tax years beginning on or after January 1, 2014. Optionally, a taxpayer may apply the repair regulations for tax years beginning on or after January 1, 2012.

For most taxpayers the final regulations formalize what they have already been doing. For other taxpayers the final regulations may cause a change in accounting method, which usually requires filing Form(s) 3115. The final regulations have a special provision for small business taxpayers. On February 13, 2015, the IRS released Rev. Proc. 2015-13, 2015-5 I.R.B. 419, and Rev. Proc. 2015-20, which provide a simplified procedure for small business taxpayers. These taxpayers can adopt changes in their method of accounting on a prospective basis (for tax years beginning January 1, 2014, and thereafter) without filing Form(s) 3115. This simplified procedure is generally available to small business taxpayers, including sole proprietors, with assets totaling less than $10,000,000 or average gross receipts of $10,000,000 or less during the past 3 years.

### Observation 2012 and 2013 Form 3115 Filing Deadline

Applying the final regulations to a tax year beginning on or after January 1, 2012, and before January 1, 2014, would have required the timely filing of Form 3115 to adopt the accounting method changes in the final regulations. Rev. Proc. 2015-20 extended the deadline for the 2012 and 2013 tax years to September 15, 2015. Because the due date of Form 3115 without this extension is 180 days from the tax return’s due date (including extensions, even if the taxpayer did not extend the due date), there may be fiscal-year taxpayers still eligible to file Form 3115 and apply the final regulations retroactively.

The exception for small business taxpayers and when it is advisable to file Form(s) 3115 under the final regulations are discussed later in this chapter.

### Observation More Changes Likely

Most leading tax experts consider the final repair regulations to be one of the most significant changes in the tax law since the Tax Reform Act of 1986, Pub. L. No. 99-514. Tax practitioners should expect additional changes to these regulations in the future due to their complex nature and the difficulty that most tax practitioners are experiencing in implementing them. Tax practitioners should also expect the IRS to issue additional guidance.

### BACKGROUND I.R.C. § 263(a) generally requires capitalization of amounts paid to acquire, produce, or improve tangible property, whereas I.R.C. § 162 allows a current deduction for ordinary and necessary business expenses, including costs for materials, supplies, repairs, and maintenance.

In the past, determining whether an expense was currently deductible or whether it must be capitalized and depreciated required a careful examination and thorough understanding of all the particular facts and circumstances related to the nature of the taxpayer’s particular industry and its business operations. This created both uncertainty about the proper treatment of an expense and frequent discussions with the IRS. The final regulations are intended to clarify the existing law in the Internal Revenue Code and court decisions.
In *Illinois Merchandise Trust Co. v. Commissioner*, 4 B.T.A. 103 (1926), *acq.* 2 C.B. 2 (1926), the Board of Tax Appeals (the Tax Court’s predecessor) provided guiding principles:

In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend... [A repair’s purpose is to keep] 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 final regulations are organized as follows:

1. Treas. Reg. § 1.162-3 provides rules for deducting the cost of materials and supplies.
3. Treas. Reg. § 1.263(a)-1 provides general rules for capital expenses.
4. Treas. Reg. § 1.263(a)-2 provides rules for amounts paid to acquire or produce tangible property.
5. Treas. Reg. § 1.263(a)-3 provides rules for amounts paid to improve tangible property.

Figure 10.1 summarizes the final regulations by subject area.

**FIGURE 10.1 Summary of Final Regulations**

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<th>Topic</th>
<th>Regulation</th>
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Improvements to Property

Facts and circumstances continue to play an important role in determining whether expenses are deductible repairs or capital improvements.

Treas. Reg. § 1.263(a)-3 provides the rules to distinguish between repairs and capital improvements. It integrates the basic rules and concepts developed over the years in court cases and IRS guidance, but there is still no definitive test. Thus, facts and circumstances continue to play an important role in determining whether an expense is a deductible repair cost or a capital improvement.

Treas. Reg. § 1.162-4(a) states that a taxpayer “may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized.”

Small Taxpayer Safe Harbor

A small taxpayer safe harbor that allows the taxpayer to deduct limited amounts of capital improvements is discussed later in this chapter.

Treas. Reg. § 1.263(a)-3(d) states that an amount paid after the taxpayer places a unit of property in service is paid for an improvement if the amount paid

1. results in a betterment to the unit of property,
2. restores the unit of property, or
3. adapts the unit of property to a new or different use.

Taxpayers must capitalize all of an improvement’s direct costs and any indirect costs (including, for example, otherwise deductible repair costs) that directly benefit or are incurred by reason of the improvement [Treas. Reg. § 1.263(a)-3(g)(1)]. Taxpayers do not have to capitalize indirect costs arising from activities that do not directly benefit (and are not incurred by reason of) an improvement, even if the activities are performed at the same time as an improvement.

A taxpayer generally must capitalize related amounts that might be paid in a different tax year. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed.

Example 10.1 Repairs Completed with Improvements

Jeff Jones operates Jeff’s Hauling, a petroleum hauling company. He replaced the existing engine, cab, and petroleum tank for one of the company trucks with a new engine, cab, and tank that constitute improvements. At the same time, Jeff painted the new cab with the company logo and replaced a broken taillight on the truck.

The cost of painting the logo must be capitalized because the need for it arose from replacing the old cab with a new cab. (Repainting a logo would otherwise be a deductible repair.) The amount paid to repair the broken taillight does not directly benefit the improvement and was not incurred because the cab and the engine were replaced, even though the repair was performed at the same time. Thus Jeff’s Hauling is not required to capitalize the amount paid to repair the broken taillight [Treas. Reg. § 1.263(a)-3(k)(7), Example 11].

Homeowner May Capitalize Some Repairs

A taxpayer who is an individual may capitalize amounts paid for repairs and maintenance if they are made at the same time as capital improvements, and they are made to units of property not used in the taxpayer’s trade or business or for the production of income. The amounts must be paid as part of an improvement (for example, a remodel) to the taxpayer’s residence [Treas. Reg. § 1.263(a)-3(g)(1)(ii)]. If these repair expenses are characterized as capital improvements under the regulations, they increase basis and reduce gain on the sale of the property.
A federal, state, or local regulator’s requirement that a taxpayer perform certain repairs or maintenance on a unit of property to continue operating the property is not relevant in determining whether the amount paid improves the unit of property [Treas. Reg. § 1.263(a)-3(g)(4)].

Whether an expenditure results in a betterment depends on quantitative and qualitative factors. Materiality is always a factor. Treas. Reg. § 1.263(a)-3(j)(1) defines a betterment as an expenditure that

1. 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 property), whether or not the taxpayer was aware of the condition or defect at the time of acquisition;
2. is for a material addition to the unit of property, such as a physical enlargement, expansion, extension, or addition of a new major component;
3. is for a material increase in the unit of property’s capacity, such as additional linear space or cubic feet; or
4. is reasonably expected to materially increase the unit of property’s productivity, efficiency, output, strength, or quality.

The applicability of these criteria to a particular unit of property depends on the nature of the unit of property.

The examples in this section illustrate only the application of the I.R.C. § 263(a) rules. They do not address whether another tax law (for example, I.R.C. § 263A) requires capitalization.

**Examples**

The following examples illustrate which expenditures constitute a betterment.

**Example 10.2 Preexisting Material Condition**

Fresh Food, LLC purchased a store located on land that contained underground gasoline storage tanks left by prior occupants. The tanks leaked prior to Fresh Food’s purchase of the property, and they had contaminated the soil. Fresh Food was not aware of the contamination at the time of the purchase.

Fresh Food later discovered the contamination and remediated the soil. The remediation costs result in a betterment because the costs were incurred to ameliorate a material condition or defect that existed prior to Fresh Food’s acquisition of the land. The costs must be capitalized [Treas. Reg. § 1.263(a)-3(j)(3), Example 1].

**Example 10.3 No Preexisting Material Condition**

Paige Turner owns an office building that was constructed with insulation that contained asbestos. Several years after Paige placed the building in service, she discovered that certain areas of the insulation had begun to deteriorate and could eventually pose a health risk to employees. Paige
hired a contractor to remove the insulation from the building and replace it with new insulation that is safer but no more efficient or effective than the asbestos insulation.

The presence of asbestos insulation in a building, by itself, is not a preexisting material condition or defect in the building structure. The removal and replacement of the asbestos is not a material addition to the building structure and is not a material increase in the capacity of the property when compared to the condition of the property prior to the deterioration of the insulation. Although the building may be safer without the asbestos insulation, the new insulation is not reasonably expected to materially increase the capacity, productivity, efficiency, strength, quality, or output of the building. Consequently, the costs to remove and replace the insulation are treated as deductible repairs [Treas. Reg. § 1.263(a)-3(j)(3), Example 2].

Example 10.5 Relocation and Reinstallation of Equipment
Jazz Manufacturing operates a manufacturing facility in Building A, which contains various machines that Jazz uses in its manufacturing business. Jazz decided to expand part of its operations by relocating a machine to Building B. Jazz disassembled the machine, moved the machine to Building B, and reinstalled the machine in a new configuration with additional components. The reinstallation, including the reconfiguration and the addition of components, increased the capacity of the machine and therefore was a betterment to the machine. Consequently, Jazz must capitalize the costs of reinstalling the machine as an improvement to the machine. Jazz must also capitalize the costs of disassembling and moving the machine to Building B because these costs directly benefit and were incurred by reason of the improvement to the machine [Treas. Reg. § 1.263(a)-3(j)(3), Example 10].

Example 10.6 Not a Material Increase in Capacity of a Building
Peek Properties owns a building used in its real estate business. The first floor has a drop ceiling. To fully expose windows on the first floor, Peek paid to remove the drop ceiling and repaint the
Comparison of Property Condition

To apply the betterment factors, the taxpayer must compare the condition of the unit of property immediately after the expenditure to its condition immediately before the circumstances necessitating the expenditure [Treas. Reg. § 1.263(a)-3(j)(2)(iv)(A)].

Normal Wear and Tear

If the expenditure is required because of normal wear and tear, Treas. Reg. § 1.263(a)-3(j)(2)(iv)(B) provides that the condition of the unit of property “immediately before the circumstances necessitating the expenditure” is

- its condition 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 unit of property when it was placed in service by the taxpayer.

Example 10.7 Material Increase in Efficiency

Star Service owns a building that it uses in its service business. Star conducted an energy assessment and determined that it could significantly reduce its energy costs by adding insulation to its building. Star paid an insulation contractor to apply a combination of loose-fill, spray foam, and blanket insulation throughout the building structure, including the attic, walls, and crawl spaces. Star reasonably expects the new insulation to make the building more energy-efficient because the contractor indicated that the new insulation would reduce its annual energy and power costs by approximately 50% of its annual costs during the last 5 years.

Star must capitalize the amount paid to add the insulation because the insulation is reasonably expected to materially increase the efficiency of the building structure [Treas. Reg. § 1.263(a)-3(j)(3), Example 21].

Question.

Does the treatment of the cost change if the new insulation will reduce Star’s annual energy and power costs by only approximately 30% of its annual costs during the last 5 years?

Answer.

Based on a strict interpretation of the regulations, it is more likely than not that addition of the insulation is a repair, and Star is not required to treat the insulation costs as a betterment.
condition of the system prior to the climate control problems. Therefore, the replacement units are not betterments, and Roover is not required to capitalize amounts paid for the units [Treas. Reg. § 1.263(a)-3(j)(3), Example 20].

**Damage to Unit of Property**

If the taxpayer corrects damage to a unit of property that occurred during the taxpayer’s use, the condition of the property “immediately before the circumstances necessitating the expenditure” is the condition of the property immediately before the damage [Treas. Reg. § 1.263(a)-3(j)(2)(iv)(C)].

**Practitioner Note**  
Restoration to Its Original Condition

As long as the damaged property is restored only to its original condition, there is no betterment. However, the restoration rules (discussed later in this section) require capitalization of the costs of restoring property resulting from a casualty to the extent that a casualty loss reduced the property’s basis.

**Cross-Reference**  
Casualty Loss Example

See page 482 in the 2013 National Income Tax Workbook for a discussion of the casualty loss rule under the final regulations.

**Practitioner Note**  
Unavailability of Replacement Parts

If a part cannot be replaced with the same type of part because of technological advances or product enhancements, replacing the part with an improved but comparable part does not by itself result in a betterment to the unit of property [Treas. Reg. § 1.263(a)-3(j)(2)(ii)].

**Refreshing a Building**

Certain costs to refresh the look of a building are not betterments and can be expensed as repairs. Examples in the final regulations illustrate which building refresh costs are repair costs and which costs are betterments that must be capitalized and depreciated. The examples also illustrate the distinctions between refresh and improvement activities when a taxpayer simultaneously undertakes multiple activities for a building (e.g., when the taxpayer makes cosmetic changes and also adds additional space).

**Practitioner Note**  
Some Repairs Must Still Be Capitalized

As explained earlier, Treas. Reg. § 1.263(a)-3(g)(1)(i) provides that otherwise deductible repair costs that directly benefit or are incurred by reason of an improvement must be capitalized along with the costs of the improvement.

**Cross-Reference**  
Building Refresh Examples


**Restorations**

Costs to restore a unit of property must be capitalized. Treas. Reg. § 1.263(a)-3(k)(1) provides that an amount restores a unit of property if it meets any one of six tests:

1. The expense is for the replacement of a component of a unit of property for which the taxpayer has properly deducted a noncasualty loss (such as an abandonment loss).

2. The expense is for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss from the sale or exchange of the component.
3. The expense is for the restoration of damage to a unit of property for which the taxpayer was required to take a basis adjustment as a result of a casualty loss. (This rule’s application is limited to amounts paid to restore the property’s adjusted basis to its basis before the casualty loss deduction.)

4. The expense returns a 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.

5. The expense results in the rebuilding of a unit of property to a like-new condition after the end of its class life.

6. The expense is for the replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property.

**Practitioner Note**

**Salvage Value Loss Exceptions**

Amounts paid under items 1 or 2 in the preceding list are not a restoration if the unit of property has been fully depreciated and the loss is attributable only to the remaining salvage value that is computed for federal income tax purposes.

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**Cross-Reference**

**Restoration Examples**

See pages 330–331 in the 2014 *National Income Tax Workbook* for examples of restorations of deteriorated property and rebuilding a unit of property to a like-new condition.

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**Planning Pointer**

**Comprehensive Maintenance Treated as Deductible Repair**

Example 9 in Treas. Reg. § 1.263(a)-3(k)(7) clarifies that expenditures made under comprehensive maintenance programs, although substantial, generally do not return a unit of property to a like-new condition, and therefore are treated as deductible repairs. This includes comprehensive maintenance performed on a unit of property after the end of its class life.

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**Replace a Major Component or Substantial Structural Part**

Taxpayers must capitalize costs as restoration expenditures when they replace a part or combination of parts that comprise a major component or substantial structural part of a unit of property [Treas. Reg. § 1.263(a)-3(k)(1)(vi)].

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 a unit of property, Treas. Reg. § 1.263(a)-3(k)(6)(i) states that it is appropriate to consider all the facts and circumstances, including both the **quantitative and qualitative** significance of the part or combination of parts in relation to the unit of property.

The regulation defines a **major component** as a part or combination of parts that performs a discrete and critical function in the operation of the

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**Restore Deteriorated Unit of Property**

When a taxpayer allows a unit of property to deteriorate to a point that it is no longer fit for its intended use, the taxpayer must capitalize the costs of returning the property to its ordinarily efficient operating condition [Treas. Reg. § 1.263(a)-3(k)(1)(iv)].

**Return to Like-New Condition**

Costs to rebuild a unit of property to a like-new condition after the end of its class life must be capitalized, whereas similar work performed before the end the property’s class life may be deductible as a repair cost unless it is for the replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property.

A unit of property is considered rebuilt to like-new condition if the property is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer’s original specifications. Generally, a comprehensive maintenance program, even though substantial, does not return a unit of property to a like-new condition [Treas. Reg. § 1.263(a)-3(k)(5)].
Answer 1.
No. The 200 windows comprise a significant portion of a major component of the building structure, so the replacement of the windows is the replacement of a major component of the building structure. Accordingly, Hanson must treat the amount paid to replace 200 windows as a restoration of the building and must capitalize the amount paid as an improvement to the building [Treas. Reg. § 1.263(a)-3(k)(7), Example 26].

Question 2.
Does the size of the windows make a difference?
Answer 2.
Yes. Assume that the building is a modern design, the 300 windows represent 90% of the total surface area of the building, and Hanson replaces 100 of the 300 windows. The 100 windows still do not comprise a significant portion of a major component of the building structure, but they do comprise a substantial structural part of the building structure. Therefore, the replacement of 100 windows comprises the replacement of a substantial structural part of the building structure. Accordingly, Hanson must treat the amount paid to replace the 100 windows as a restoration of the unit of property and must capitalize the amount paid as an improvement to the building [Treas. Reg. § 1.263(a)-3(k)(7), Example 27].

Example 10.9 Significant Portion of a Major Component
Hanson Printing, Inc. owns an office building that has 300 exterior windows. The 300 windows represent 25% of the total surface area of the building. In 2015 Hanson replaced 100 windows that had become damaged. At the time of these replacements, Hanson had no plans to replace any other windows in the near future. The 300 windows constitute a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. However, 100 windows do not comprise a significant portion of the major component. Therefore, the replacement of 100 windows does not constitute the replacement of a major component or substantial structural part of the building, and Hanson is not required to treat the amount paid to replace the 100 windows as a restoration of the building [Treas. Reg. § 1.263(a)-3(k)(7), Example 25].

Question 1.
Can Hanson deduct as a repair the cost of replacing 200 windows?

Example 10.10 Replacement of Furnace Not a Major Component
Master Care owns a building in which it operates an office that provides medical services. The building contains one HVAC system, which is comprised of three furnaces, three air conditioning units, and duct work that distributes the hot or cold air throughout the building. One furnace in the building broke down, and Master Care replaced it with a new furnace. The HVAC system, including the furnaces, is a building system. The parts that provide the heating function in the system, the three furnaces, together perform a discrete and critical function in the operation of the HVAC system and are therefore a major component of the HVAC system. However, the single furnace is not a significant portion of the HVAC system or a substantial structural part of the HVAC system. Therefore, Master Care is not required to treat the amount paid to replace
the furnace as a restoration of the building, and it treats the amount paid as a deductible repair [Treas. Reg. § 1.263(a)-3(k)(7), Example 16].

Example 10.11 Replacement of Chiller Unit Is a Major Component
Nimble Consulting owns a large office building in which it provides consulting services. The building contains one HVAC system, which is comprised of one chiller unit, one boiler, pumps, duct work, diffusers, air handlers, an outside air intake, and a cooling tower. The chiller unit includes the compressor, evaporator, condenser, and expansion valve, and it functions to cool the water used to generate the air conditioning throughout the building. Nimble replaced the chiller with a comparable unit. The HVAC system, including the chiller unit, is a building system. The chiller unit performs a discrete and critical function in the operation of the HVAC system because it provides the cooling mechanism for the entire system. Therefore, the chiller unit is a major component of the HVAC system. Because the chiller unit is a major component of a building system, Nimble must treat the amount paid to replace the chiller as an improvement to the building and therefore must capitalize the amount paid [Treas. Reg. § 1.263(a)-3(k)(7), Example 17].

Example 10.12 Replacement of Plumbing System Is a Major Component
Star Shoe Outlet owns a building in which it conducts a retail business. The retail building has three floors. The retail building has men’s and women’s restrooms on two of the three floors. Star decided to update the restrooms and replaced the plumbing fixtures in all of the restrooms, including all the toilets and sinks, with modern-style plumbing fixtures of similar quality and function. Star did not replace the pipes connecting the fixtures to the building’s plumbing system. The plumbing system, including the plumbing fixtures, is a building system. All the toilets together perform a discrete and critical function in the operation of the plumbing system, and all the sinks together also perform a discrete and critical function in the operation of the plumbing system. Therefore, all of the toilets and all of the sinks comprise a major component of the plumbing system. Accordingly, Star must treat the amount paid to replace all of the toilets and sinks as a restoration of the building and must capitalize the amount paid as an improvement to the building [Treas. Reg. § 1.263(a)-3(k)(7), Example 22].

Question.
What if only 8 out of 20 sinks were replaced? Does that make a difference?

Answer.
Yes. The 8 replaced sinks by themselves do not comprise a significant portion of a major component (the 20 sinks) of the plumbing system, and they do not comprise a large portion of the physical structure of the plumbing system. Therefore, the replacement of 8 sinks does not constitute the replacement of a major component or structural part of the building, and it is not a restoration of the building. Accordingly, Star is not required to capitalize the replacement costs [Treas. Reg. § 1.263(a)-3(k)(7), Example 23].

Example 10.13 Flooring Replacement Not a Major Component
Victory owns and operates a hotel building. Victory decided to refresh the appearance of the hotel lobby by replacing the floors in the lobby. The hotel lobby comprises less than 10% of the square footage of the entire hotel building. Victory paid to replace the wood flooring in the lobby with new wood flooring of a similar quality. Victory did not replace any other flooring in the building. The wood flooring is section 1250 property. The wood flooring is a part of the building structure. All of the floors in the hotel building comprise a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. However, the lobby floors are not a significant portion of a major component (that is, all the floors), and the lobby floors are not a substantial structural part of the building structure. Therefore, the replacement of the lobby floors is not the replacement of a major component or substantial structural part of the building, and Victory is not required to capitalize the amount paid for the replacement of the lobby floors as a restoration. Accordingly, Victory treats the amount paid as a deductible repair [Treas. Reg. § 1.263(a)-3(k)(7), Example 28].
Question 1.
What if Victory replaced the flooring in all public areas of the hotel? Does it make a difference?

Answer 1.
Yes. The public areas (lobby, hallways, meeting rooms, bathrooms, and other public rooms throughout the hotel interior) comprise approximately 40% of the square footage of the entire hotel building. The floors in all the public areas of the hotel comprise a significant portion of a major component (that is, all the building floors) of the building structure. Therefore, the replacement of all public area floors constitutes the replacement of a major component of the building structure. Accordingly, Victory must treat the amount paid to replace the public area floors as a restoration of the building unit of property and must capitalize the amounts paid as an improvement to the building [Treas. Reg. § 1.263(a)-3(k)(7), Example 29].

Question 2.
What if the flooring in all public areas of the hotel comprised approximately 30% of the square footage of the entire hotel building? Does it make a difference?

Answer 2.
Based on a strict interpretation of the regulations, it is more likely than not that it would not comprise a significant portion of a major component (that is, all the building floors) of the building structure. Accordingly, the amounts paid to replace the public area floors would be treated as a deductible repair.

Partial Disposition Election
A disposition of an asset occurs when the taxpayer permanently withdraws the asset from use in a trade or business or in the production of income. This can be the result of a sale or exchange, physical abandonment, or a charitable contribution of the asset.

Treas. Reg. § 1.168(i)-8(d)(2) allows a taxpayer to elect to report a gain or loss on the disposition of a portion of an asset that is properly included in asset classes 00.11 through 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674, if the taxpayer classifies the replacement portion of the asset under the same asset class as the disposed portion of the asset.

In many cases the partial disposition election is optional; however, a taxpayer must make a partial disposition election in the following situations:

1. A disposition of a portion of an asset as a result of a casualty described in I.R.C. § 165
2. A disposition of a portion of an asset for which gain is not recognized in whole or in part under I.R.C. § 1031 or I.R.C. § 1033
3. A transfer of a portion of an asset in a step-in-the-shoes transaction described in I.R.C. § 168(i)(7)(B)
4. A sale of a portion of an asset

The election may be made for any portion of a disposed-of asset regardless of the size of the portion. However, if the election is made, no repair deduction can be claimed with respect to the new replacement component [Treas. Reg. § 1.263(a)-3(k)(1)].

A taxpayer generally makes the election by reporting the gain, loss, or other deduction on the taxpayer’s timely filed (including extensions) original federal tax return for the tax year in which the taxpayer disposes of the portion of an asset.

Generally, abandoning a component of an asset results in a loss deduction that is equal to the component’s adjusted basis if the taxpayer makes the partial disposition election. A taxpayer may use any reasonable method to determine the adjusted basis of the disposed portion of the asset and resulting loss deduction if it is not practicable to do so using the taxpayer’s books and records [Treas. Reg. § 1.168(i)-8(f)]. Permissible methods include the following:

■ The Producer Price Index (PPI) rollback
■ Cost segregation studies
■ Factorial comparisons
The PPI is a family of indexes that measures the average change over time in selling prices received by domestic producers of goods and services. PPIs measure price change from the perspective of the seller. This is in contrast to other indexes, such as the Consumer Price Index (CPI), that measure price change from the purchaser’s perspective. Sellers’ and purchasers’ prices may differ due to government subsidies, sales and excise taxes, and distribution costs.

CPI Not Permissible

Taxpayers were allowed to use the CPI under the proposed regulations, but it is an impermissible method to determine adjusted basis under the final regulations.

Example 10.14 PPI Rollback Method

On July 1, 2012, Elite Properties, a calendar-year taxpayer, purchased and placed in service an existing multistory office building that cost $20,000,000. The cost of each structural component of the building was not separately stated. Elite accounts for the building and its structural components in its tax and financial accounting records as a single asset with a cost of $20,000,000.

Elite depreciated the building as nonresidential real property and used the optional depreciation table that corresponds with the general depreciation system, the straight-line method, a 39-year recovery period, and the midmonth convention. As of January 1, 2015, the accumulated depreciation for the building was $1,261,000.

On June 30, 2015, Elite replaced one of the two elevators in the office building. Elite did not dispose of any other structural components of the building in 2015 or prior years. Elite makes the partial disposition election for the elevator. Although the office building, including its structural components, is the asset for disposition purposes, the result of Elite making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition.

The replacement elevator is a restoration under Treas. Reg. § 1.263(a)-3(k), and not a betterment under Treas. Reg. § 1.263(a)-3(j), or an adaptation to a new or different use under Treas. Reg. § 1.263(a)-3(l). Because Elite cannot identify the cost of the elevator from its records, and the replacement elevator is a restoration, Elite determined the cost of the retired elevator by discounting the cost of the replacement elevator to its placed-in-service year cost using the PPI for final demand. Using this reasonable method, Elite determined the cost of the retired elevator is $150,000, which is the cost of the replacement elevator discounted to its cost in 2012 (the placed-in-service year). Thus, $150,000 of the $20,000,000 purchase price for the building is the cost of the retired elevator.

Using the optional depreciation table that corresponds with the general depreciation system, the straight-line method, a 39-year recovery period, and the midmonth convention, the depreciation allowed or allowable for the retired elevator as of December 31, 2014, is $9,458. Elite determined its 2015 loss for the retired elevator as follows. The depreciation allowed or allowable for 2015 for the retired elevator is $1,763 \([($150,000 unadjusted depreciable basis \times 2.564\% \text{ depreciation rate for 2015}) \times (5.5 ÷ 12 \text{ months})]\). Thus, the adjusted depreciable basis of the retired elevator is $138,779 \(($150,000 elevator cost – $9,458 accumulated depreciation – $1,763 depreciation allowed or allowable for 2015)\). As a result, Elite recognizes a $138,779 loss for the retired elevator in 2015.

Elite’s 2015 depreciation allowance for the building is computed as follows. As of January 1, 2015, the unadjusted depreciable basis of the building is reduced from $20,000,000 to $19,850,000 \(($20,000,000 – $150,000 unadjusted depreciable basis for the retired elevator)\), and the depreciation reserve of the building is reduced from $1,261,000 to $1,251,542 \(($1,261,000 – $9,458 depreciation allowed or allowable for the retired elevator as of December 31, 2014)\). Consequently, the 2015 depreciation allowance for the building is $508,954 \(($19,850,000 \times 2.564\% \text{ depreciation rate for 2015})\).

Elite must also capitalize the amount paid for the replacement elevator pursuant to Treas. Reg. § 1.263(a)-3(k)(1). The replacement elevator is a separate asset for disposition purposes and for depreciation purposes.
If there was a tax basis adjustment to the building, such as the adjustment required in a section 1031 tax-free exchange, the taxpayer must apply an additional reduction factor.

Example 10.17 Property Acquired through I.R.C. § 1031 Exchange

Assume, in addition to the facts in Examples 10.15 and 10.16, that Elite acquired the building in a section 1031 exchange, reducing its depreciable basis to $750,000. Because the basis reduction must be applied to all the building components, the relative basis of the elevator should be reduced by another 50%.

The PPI rollback method does not account for the condition of the building component at the time of acquisition, so it may grossly overstate the taxpayer’s retirement loss deduction. The IRS is not obligated to accept a determination of component basis using the PPI discounting method if it does not result in a reasonable value.

Example 10.15 PPI Rollback Method Results in Overstatement of Loss

Elite Properties acquired another building 3 years ago. This year, Elite spent $200,000 to replace the elevator. Discounting the cost of the replacement elevator back 3 years using the PPI index assumes that the elevator was new at the time of acquisition. Because the elevator had only 3 years of life left at the time of acquisition, an appropriate “condition factor” should be applied to account for the elevator’s condition at the time of the acquisition, and to avoid overstating the basis of the retired elevator.

If a unit of property was purchased at a discount or involves a basis adjustment, the PPI rollback method can cause a material overstatement of the basis. The regulations suggest using a pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed portion of the asset and the replacement cost of the (entire) asset.

Example 10.16 PPI Rollback Method When Property Acquired at a Discount

Assume the same facts as Example 10.15, except that the building was in foreclosure at the time of sale and Elite paid a discounted price of $1,500,000. The cost to reconstruct the building 3 years ago was $2,500,000. Because all the building components were purchased at a 60% discount, the basis of the old elevator must be reduced by 60%.

The following are examples of betterments and adaptations where the PPI rollback method cannot be used to value components removed:

1. A substantial remodel to a store that results in betterment to the building’s structure and systems [Treas. Reg. § 1.263(a)-3(j)(3), Example 8]
2. Addition of a mezzanine and a stairway in a retail store when the additions materially increase the capacity of the store [Treas. Reg. § 1.263(a)-3(j)(3), Example 19]
3. Addition of insulation that substantially increases the energy efficiency of the building [Treas. Reg. § 1.263(a)-3(j)(3), Example 21]
5. Regrading commercial land so it can be used for residential purposes [Treas. Reg. § 1.263(a)-3(l)(3), Example 4]
Restorations

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Applewood determined that it was necessary to replace the roofing shingles on 2 of its 10 buildings by laying new but comparable shingles on top of the roof. The roof structure itself did not require any work. The cost of replacing shingles of a roof with comparable shingles is generally considered a repair and maintenance expense under the repair regulations. Therefore, Applewood Apartments must treat the reroofing work as a currently deductible repair and may not capitalize the expenditure on its tax return [unless the expenditure resulted from a casualty or if the taxpayer elected to apply the partial asset disposition rules on the preexisting (old) shingles].

Question 1.
What if Applewood replaced the roofing shingles on all 10 of its buildings at the same time?

Answer 1.
Because the roofing shingles deteriorated during Applewood’s ownership, it is not a restoration, adaptation, betterment, or improvement, and such expenditures are still treated as a currently deductible repair.

Question 2.
What if the roofing shingles would have been replaced within a year or two after Applewood purchased the apartment complex?

Answer 2.
Because it is more likely than not that the roofing shingles deteriorated during the previous ownership (and not Applewood’s ownership), the expenditures would be considered a restoration, and such expenditures must be capitalized as an improvement. In this case the taxpayer should consider making a partial disposition election on the old roof(s), which would allow the taxpayer to deduct a loss on the disposition of the original roofing shingles equal to any remaining adjusted basis.

Question 3.
How are the removal costs treated when incurred in connection with the replacement of the old roofing shingles if the activity is a repair?

Answer 3.
If the replacement of the roofing shingles is a currently deductible repair, then the taxpayer must deduct the removal costs associated with the reroofing work, regardless of whether the removal costs are treated as a repair or an improvement.
removal costs were separately stated on the invoice, because the removal costs were incurred by reason of a repair or maintenance to the building structure.

**Question 4.**
How are the removal costs of the old roofing shingles treated by the taxpayer if the reroofing work is an improvement to the building structure and the taxpayer made a partial disposition election and deducted the adjusted basis of the old shingles as a loss on the disposition?

**Answer 4.**
Even though the amount paid for reroofing work is an improvement to the building structure, the taxpayer must still deduct the removal costs associated with disposing of the old roofing shingles, regardless of their relation to the improvement.

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**Planning Pointer**

**Documenting Removal Costs**

The final regulations specifically state that removal costs must be treated as a currently deductible repair (and should not be capitalized). Thus, practitioners should advise their clients to obtain invoices from contractors separately stating any removal costs for all work performed.

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**Observation**

**Change in Accounting Method**

If a taxpayer capitalized removal costs in 2012 or 2013 and now wants to deduct those removal costs under the final regulations, the taxpayer must file for a change in accounting method (Form 3115) by the applicable due date (as discussed earlier in the chapter). This method change number 21 is not one of the simplified accounting method changes authorized under Rev. Proc. 2015-20 (discussed later).

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**Example 10.19 Component Removed during Improvement**

Xavior Corp. owns a factory building with a storage area on the second floor. Xavior Corp. paid to remove the original columns and girders supporting the second floor and replaced them with new columns and girders to permit storage of supplies with a gross weight that is 50% greater than the previous load-carrying capacity of the storage area. As a result, the replacement of the columns and girders constitutes an improvement to the building structure [Treas. Reg. § 1.263(a)-3(g)(2)(ii), Example 1].

**Question 1.**
How are the costs to remove the original columns and girders treated?

**Answer 1.**
Because the amount paid to remove the original columns and girders was incurred by reason of the improvement to the building, Xavior Corp. must capitalize the removal costs as part of the improvement. Xavior must also capitalize the cost to replace the columns and girders.

**Question 2.**
How are the costs to remove the original columns and girders treated if Xavior Corp. disposes of the original columns and girders and elects to treat the disposal of these structural components as a partial disposition of the building?

**Answer 2.**
Because Xavior made the partial disposition election, Xavior does not have to capitalize the cost to remove the original columns and girders as part of the cost of the improvement. Xavior must still capitalize the cost to replace the columns and girders [Treas. Reg. § 1.263(a)-3(g)(2)(ii), Example 2].

**Question 3.**
What if the new columns and girders allow the storage of supplies with a gross weight that is only 25% greater than the previous load-carrying capacity of the storage area? Would the costs of replacing the columns and girders still be capitalized?

**Answer 3.**
It is more likely than not that a 25% increase in the load-carrying capacity of the storage area would not be considered a material increase in the capacity of the building structure, and therefore Xavior must expense the costs as a repair.

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**Example 10.20 Component Removed during Repair or Maintenance**

Yoder Quilting owns a building in which it conducts its retail business. The roof on Yoder's
building is covered with shingles. Over time the shingles began to wear, and the roof leaked into the retail premises. However, the building still functioned in Yoder’s business.

To eliminate the problem, Yoder paid a contractor to replace the old shingles with new but comparable shingles that corrected the leakage problems. The replacement of old shingles with new shingles to correct the leakage is not a betterment or a restoration of the building structure or systems and does not adapt the building structure or systems to a new or different use. Therefore, the amounts Yoder paid to replace the shingles are not improvements to the building unit of property, the costs are deductible as repair or maintenance costs, and the removal costs are included in the repair costs [Treas. Reg. § 1.263(a)-3(g)(2)(ii), Example 3].

**Question.**
Is the answer different if Yoder disposed of the original shingles, elected to treat the disposal of these components as a partial disposition of the building, and deducted the adjusted basis of the original shingles as a loss on the disposition?

**Answer.**
Yes. Amounts paid for replacement of the shingles constitute a restoration of the building structure when the taxpayer has properly deducted a loss for that component. Yoder must capitalize and depreciate the amounts paid for the replacement shingles as an improvement to the building unit of property. However, the amounts Yoder paid to remove the original shingles are not required to be capitalized as part of the cost of the improvement, regardless of their relation to the improvement [Treas. Reg. § 1.263(a)-3(g)(2)(ii), Example 4].

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**Example 10.21 Combining Three Leased Spaces**

Broadstone Properties owns and leases out space in a building consisting of 20 retail spaces. The space was designed to be reconfigured; that is, adjoining spaces could be combined into one space. One of the tenants expanded its occupancy by leasing two adjoining retail spaces. To facilitate the new lease, Broadstone paid to remove the walls that separated the three retail spaces. The walls between the spaces were part of the building and its structural components.

The conversion of three retail spaces into one larger space for an existing tenant does not adapt Broadstone’s building structure to a new or different use because the combination of retail space is consistent with Broadstone’s intended use of the building structure. Therefore, the amount paid by Broadstone to remove the walls does not improve the building, and Broadstone is not required to capitalize the expense. Instead Broadstone deducts the amounts as a repair [Treas. Reg. § 1.263(a)-3(l)(3), Example 2].

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**Example 10.22 Preparing Building for Sale Not an Adaptation**

Crystal Properties owns a building consisting of 20 retail spaces. Crystal decided to sell the building. In anticipation of selling the building, Crystal paid to repaint the interior walls and to refinish the hardwood floors.

Preparing a building for sale does not constitute a new or different use for the building structure. Therefore, the amount paid by Crystal to prepare the building structure for sale does not improve the building, and Crystal does not have to capitalize the expenses. Instead Crystal expenses the amounts as a repair [Treas. Reg. § 1.263(a)-3(l)(3), Example 3].

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**Example 10.23 Modifying Part of Building**

General Hospital owns a hospital building with various departments dedicated to the provision of clinical medical care. To better accommodate the patients’ needs, General decided to modify...
the emergency room to provide both emergency care and outpatient surgery. General moved interior walls, added additional wiring and outlets, replaced floor tiles and doors, and repainted the walls. To complete the outpatient surgery center, General also installed medical equipment that is necessary for the provision of surgical services. The medical equipment is section 1245 property. General treats the amounts paid for the equipment as costs of acquiring new units of property, and thus must capitalize the amounts paid.

The amounts paid to convert part of General’s emergency room into an outpatient surgery center do not adapt General’s building structure or electrical system to a new or different use, because the provision of outpatient surgery is consistent with General’s intended, ordinary use of the building structure and the systems in its clinical medical care business. Accordingly, the amounts paid by General to relocate interior walls, add additional wiring and outlets, replace floor tiles and doors, and repaint the walls to create outpatient surgery space do not improve the building, and General is not required to capitalize such costs [Treas. Reg. § 1.263(a)-3(l)(3), Example 7].

UNIT OF PROPERTY
Establishing the unit of property is essential to determine whether alterations to tangible property are classified as repairs or as capital expenses.

The replacement of a major component or substantial structural part of a unit of property is an improvement that must be capitalized and depreciated. Generally, the larger the unit of property, the more likely it is that the changes can be characterized as deductible repairs rather than capital improvements. On the other hand, the smaller the unit of property, the more likely it is that the alterations will be characterized as capital improvements rather than deductible repairs.

Treas. Reg. § 1.263(a)-3(e) provides that, in general, a unit-of-property determination for property other than buildings is based on a functional interdependence standard. All components that are functionally interdependent comprise a single unit of property. Components are functionally interdependent if placing one component in service is dependent on placing other components in service. The regulations provide specific rules for buildings, plant property, network assets, leased property, and improvements to property. Special rules apply when a taxpayer assigns different MACRS classes or depreciation methods to components of property (or subsequently changes the class or depreciation method of a component or other item of property). Property that is aggregated or accounted for in a multiple asset account cannot be treated as a single unit of property.

De Minimis Safe Harbor Linked to Unit of Property

Treas. Reg. § 1.263(a)-1(f)(1) provides that the de minimis safe harbor (discussed later in this chapter) applies to amounts paid for the acquisition or production of a unit of tangible property. Because Treas. Reg. § 1.263(a)-3(e)(4) states that an improvement is generally not a separate unit of property from the improved property, the de minimis safe harbor would not apply to costs for those improvements.

Buildings

An entire building is a single unit of property, but the improvement rules discussed earlier in this chapter apply separately to a building and to specified building systems [Treas. Reg. § 1.263(a)-3(e)(2)(i) and (ii)]. In effect, the building structure
and each group of components that comprises a building system are treated as separate units of property.

**Building Systems**

The building systems are identified in Treas. Reg. § 1.263(a)-3(e)(2)(ii) as follows:

1. Heating, ventilation, and air conditioning (HVAC) systems, including motors, compressors, boilers, furnace, chillers, pipes, ducts, and radiators
2. Plumbing systems, including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility distribution equipment running 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 distribution equipment running to and from the property line 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 panel, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and firefighting equipment such as hoses and extinguishers
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, and associated conduits and wiring
8. Gas distribution systems, including associated pipes and equipment used to distribute gas to and from the property line and between buildings and other permanent structures
9. Any other structural components that are specifically designated as building systems in future published guidance

**Building Structure**

The building structure consists of a building and its structural components except for components of the specified building systems. Treas. Reg. § 1.48-1(e)(2) states that structural components include walls, partitions, floors, and ceilings (including any permanent coverings such as paneling or tiling); windows and doors; and other components relating to the operation and maintenance of a building.

**Leased Buildings**

When the taxpayer is a lessee of all or a portion of a building (such as an office, floor, or certain square footage), the unit of property (leased building property) is the portion of each building subject to the lease and the structural components associated with the leased portion. If a lessee leases an entire building, the lessee’s unit of property is the entire building, and the improvement rules apply to the building structure and each building system in the same manner as if the lessee owned the building.

**Example 10.24 Alterations to Restroom**

Techno Tech Co. leases office space in a large office building. Techno Tech’s office includes a single restroom for its employees’ use. If Techno Tech pays a plumber to replace the toilet and sink, the expenditure is likely to be treated as a capital improvement because the work is performed on a major portion of the plumbing system located within the leased office space. However, if the building’s owner (the lessor) pays for the same work, the cost might be considered...
a repair expense because the work affects only a small portion of the building’s entire plumbing system.

**Office Condominium**

If a taxpayer owns an individual unit in a building with multiple units (such as a condominium), the unit of property is the individual unit owned by the taxpayer and the structural components that are part of the unit. An amount is paid to improve a condominium if the amount is paid for an improvement to the building structure that is part of the condominium unit or to the portion of any building system that is part of the condominium unit.

Example 3 of Treas. Reg. § 1.263(a)-3(e)(5) discusses a medical office condominium building. The individual unit contains two restrooms, each of which contains a sink, a toilet, water and drainage pipes, and other fixtures. The unit’s owner pays for labor and materials to perform work on the pipes, sinks, toilets, and plumbing fixtures that are part of the condominium unit. The owner must treat the individual unit that it owns as a single unit of property. The pipes, sinks, toilets, and plumbing fixtures comprise the plumbing system for the individual condominium unit. Therefore, the work on the restrooms is an improvement to the plumbing system that is part of the individual condominium unit, and the owner must treat it as an improvement to the individual condominium unit.

**Tenant Improvements Performed by Landlords**

Under Treas. Reg. § 1.263(a)-3(f), a lessor must capitalize the related amounts that it pays directly, or indirectly through a construction allowance to the lessee, to improve a leased property when the lessor is the owner of the improvement. In addition, the lessor must also capitalize the related amounts that the lessee pays to improve a leased property when the lessee’s improvements constitute a substitute for rent. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed.

**Observation** Landlord Improvements for Tenants

The general rule under Treas. Reg. § 1.263(a)-3(e)(5) states that a taxpayer must treat a component (or group of components) as a separate unit of property if the taxpayer has properly treated the component as being in a different class of property (MACRS classes) than the class of the unit of property of which the component is a part, or the taxpayer has properly depreciated the component using a different depreciation method than the depreciation method of the unit of property of which the component is a part.

However, this rule is trumped by Treas. Reg. § 1.263(a)-3(f), which provides the exclusive rules for determining whether amounts paid by a taxpayer are for an improvement to leased property. Specifically, Treas. Reg. § 1.263(a)-3(f)(3)(ii) states that an amount capitalized as a lessor improvement under Treas. Reg. § 1.263(a)-3(f)(3) is not a unit of property separate from the unit of property improved.

Therefore, tenant improvements paid for by landlords do not constitute a separate unit of property, even if the tenant improvements are capitalized under a different class life (e.g., 15 years) than the building in which the tenant improvements are made.

**Subsequent Tenant Improvements**

The regulations present an important opportunity for landlords when applying the improvement criteria. Because the tenant improvements performed by the landlord are not a separate unit of property from the building in which the tenant improvements were installed, the landlord has the ability to compare its tenant improvement expenditures against the whole unit of property (the building, building structures, and/or building systems). The result may be that most tenant improvements made by the landlord, beyond the initial tenant improvements capitalized for each leased space, will be classified as a repair expense.
Example 10.25 Building Improvements by Lessor

Teddy Bear is a retailer of consumer products. In 2015 Teddy leased a building from Landmark Properties for use as a retail sales facility. Pursuant to the lease, Landmark provided a construction allowance to Teddy, which Teddy used to construct an extension to the retail sales facility for additional warehouse space. The amount paid for the extension did not exceed the construction allowance, and Landmark is treated as the owner of any improvements to the building. The extension is a betterment, and, accordingly, Landmark must capitalize the improvements. In accordance with the regulations, the extension is not treated as a unit of property separate from the building and its structural components [Treas. Reg. § 1.263(a)-3(f)(4), Example 3].

Question.
Assume that the building, including the addition, has a total of six restrooms. What if there are two restrooms in the addition, and Landmark plans to remodel both restrooms in 2016? Is Landmark required to capitalize the costs to remodel the two restrooms?

Answer.
Most likely Landmark does not have to capitalize the costs. Because the addition is not a separate unit of property from the building or its building systems, and only two out of six (33%) of the plumbing systems were remodeled, it would not constitute a substantial structural part of the building or plumbing system, and thus would not constitute a restoration. Even if higher-quality materials were used to remodel the two bathrooms, any betterment to the plumbing system would not likely be significant and thus would not constitute a betterment. Consequently, Landmark treats the costs paid to perform the tenant improvements to the two bathrooms as a deductible repair.

Example 10.26 Functionally Independent Components

Ed Vocate purchased a laptop computer and a printer for his employees to use in providing legal services to his clients. Because the computer and printer are property other than a building, the initial units of property are determined under the general rule that a unit of property is comprised of the components that are functionally interdependent.

The computer and the printer are separate units of property because one can be placed in service without the other [Treas. Reg. § 1.263(a)-3(e)(6), Example 9].

Example 10.27 Functionally Interdependent Components

Midwest Rail Lines, Inc. owns locomotives that it uses in its railroad business. Each locomotive consists of components such as an engine, generators, batteries, and chassis. The locomotive is a single unit of property because it consists entirely of components that are functionally interdependent [Treas. Reg. § 1.263(a)-3(e)(6), Example 8].

Plant Property

The term plant property means functionally interdependent machinery or equipment (not including network assets) that is used to perform an industrial process such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities.

For plant property the unit of property determined under the general rule is further 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 [Treas. Reg. § 1.263(a)-3(e)(3)(ii)].

Example 10.28 Discrete and Major Functions

Hospital Supply rents uniforms and linens. It owns and operates a plant that uses machines and equipment in an assembly line–like process to treat, launder, and prepare rental items for its customers. The plant includes two laundering lines, each of which can operate independently.
One line is used for uniforms, and the other line is used for linens. Both lines have a sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system.

The unit of property for the laundering equipment is initially determined under the general rule and is comprised of all the components that are functionally interdependent. Under this rule 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, Hospital Supply 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 in the line. Therefore, Hospital Supply 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 in the laundering line [Treas. Reg. § 1.263(a)-3(e)(6), Example 6].

Network Assets

The term network assets means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. The term includes, for example, trunk and feeder lines, pole lines, and buried conduits. It does not include building structures or building systems discussed earlier in the section on buildings, and it does not include separate property that is adjacent to but not part of a network asset, such as bridges, culverts, or tunnels.

The unit of property for network assets is determined by the taxpayer’s particular facts and circumstances, except as otherwise provided in guidance published by the IRS. The functional interdependence standard is not determinative [Treas. Reg. § 1.263(a)-3(e)(3)(iii)].

Limit for Leased Property

When personal property or real property other than a building is leased, the unit of property is typically determined under the general rule or the special rules for plant property and network assets. However, the unit of property cannot be larger than the property subject to the lease [Treas. Reg. § 1.263(a)-3(e)(3)(iv)].
Example 10.30 Improvement with Same Depreciation Method

In 2010 Paula Sellers bought a building to use as retail sales space. In 2014 she built an extension to the building to provide additional warehouse space. The extension is not a separate unit of property from the original building (the unit of property that was improved). Both the building and the extension are depreciated using a straight-line method over 39 years, but the starting dates for their recovery periods differ [Treas. Reg. § 1.263(a)-3(e)(6), Example 15].

If the depreciation period or method for a portion of a building (or components of a building) changes after the building is first placed in service, the reclassified components become a separate unit of property [Treas. Reg. § 1.263(a)-3(e)(5)]. This includes situations in which a cost segregation study performed after the building was placed in service reclassified as personal property several components that are depreciable over a shorter period than the building.

Similarly, if improvements to a building are reclassified as 15-year restaurant, leasehold, or retail improvement property in a tax year after they were first placed in service, the improvements are treated as separate units of property [Treas. Reg. § 1.263(a)-3(e)(6), Example 17].

Example 10.31 Cost Segregation Study

In 2012 Nuts and Bolts, Inc. bought and placed in service a building and parking lot for use in its retail operations. It capitalized the cost of the building and parking lot and began depreciating them as nonresidential real property over 39 years. In 2015 Nuts and Bolts completed a cost segregation study that properly determined that the parking lot qualified as 15-year property for depreciation purposes. Nuts and Bolts changed its method of accounting to use the 15-year recovery period and the 150% declining balance method of depreciation for the parking lot. Beginning in 2015 Nuts and Bolts must treat the parking lot as a separate unit of property [Treas. Reg. § 1.263(a)-3(e)(6), Example 18].
Taxpayers can deduct incidental materials and supplies, and $200 of nonincidental materials and supplies. Taxpayers must capitalize materials and supplies used in improvements. Taxpayers can deduct the cost to acquire nonincidental materials and supplies if the item costs no more than $200. Gain on the disposition of a material or supply is reported as ordinary income. Treas. Reg. § 1.162-3(c)(1) defines materials and supplies as tangible property that is used or consumed in the taxpayer’s business operations, that is not inventory, and that fits in one of the following categories:

1. A unit of property with an acquisition or production cost that is less than $200 (doubled from $100 in the temporary regulations)
2. A component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer, that is not acquired as part of any single unit of tangible property
3. Fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less beginning when the property is first used or consumed in the taxpayer’s business operations
4. A unit of property that has an economic useful life of 12 months or less, beginning when the property is first used or consumed in the taxpayer’s business operations
5. Any other tangible property identified in IRS guidance as a material or supply

Example 10.32 Bulk Purchase
In 2015 Acme Co. paid $500 for a box of 10 toner cartridges for its printers. Each cartridge is a separate $50 unit of property. In the same year Acme placed 8 of the cartridges in its printers and stored the remaining 2 cartridges for use in a later year.

The toner cartridges are materials and supplies even though the box cost more than $200 because the allocable cost of each unit is $50 ($500 ÷ 10). As a result, Acme can deduct $400 for the eight cartridges used in 2015. If Acme does not expense the cartridges under the de minimis safe harbor (discussed later in this chapter), the $50 cost of each of the remaining two cartridges is deducted in the tax year in which each cartridge is first used or consumed in Acme’s business operations [Treas. Reg. § 1.162-3(h), Example 9].

Improvements Using Materials and Supplies

Although materials and supplies are defined to include components acquired to maintain, repair, or improve a unit of property, the cost of materials and supplies that are used to improve a unit of property must be capitalized and depreciated as part of the cost of the improvement.

Example 10.33 Improvements
In 2014 Energy Systems, Inc. purchased a supply of spare parts for its business machines to use in the repair or maintenance of the machines under Treas. Reg. § 1.162-4 (repairs), or in the improvement of the machines under Treas. Reg. § 1.263(a)-3 (amounts paid to improve tangible property). The parts are not temporary, and they are not rotable spare parts (parts that can be repeatedly restored to a working condition). In 2015 Energy Systems used the spare parts to improve a machine under Treas. Reg. § 1.263(a)-3(e). Because the materials and supplies were used to improve the machine rather than to repair or maintain it, Energy Systems must capitalize the amounts paid for the spare parts under Treas. Reg. § 1.263(a)-3 [Treas. Reg. § 1.162-3(h), Example 10].

Incidental Materials and Supplies

When a taxpayer does not keep a record of consumption and does not keep physical inventories of incidental materials and supplies that are carried on hand, the cost of those materials and supplies is deductible in the tax year in which the cost is paid, provided the deduction clearly
reflects taxable income [Treas. Reg. § 1.162-3(a)(2)].

For example, a taxpayer can deduct the cost of purchasing a box of highlighters or copy paper for use in the business without tracking the amount actually consumed during the tax year.

### Planning Pointer: Safe Harbor for Nonincidental Items

If a taxpayer elects the Treas. Reg. § 1.263(a)-1(f) de minimis safe harbor (discussed in the next section of this chapter), the taxpayer must deduct the entire cost of qualifying nonincidental materials and supplies in the year the cost is paid or incurred rather than in the year the items are used or consumed in the business. Eligible items are no longer treated as materials and supplies.

### DE MINIMIS SAFE HARBOR

An exception to the capitalization rules allows eligible taxpayers to take a current deduction for items that cost less than a specified amount.

Treas. Reg. § 1.263(a)-1(f)(1) provides a de minimis safe harbor that is potentially available to all business taxpayers. The safe harbor permits a current-year deduction (when the cost is paid or incurred) for the acquisition or production of units of tangible property that have an economic useful life that does not exceed 12 months or that cost less than a specified amount, even if I.R.C. § 263(a) otherwise would require capitalization of the item's cost, or if Treas. Reg. § 1.162-3 would require the taxpayer to deduct the amount paid when the property is first used or consumed in the business. The amount paid must meet the threshold test of being a trade or business expense under I.R.C. § 162.

Although the taxpayer’s accounting procedures can set any dollar limit for expensing, the per item tax deduction is limited to $500 for taxpayers without an applicable financial statement (AFS) and $5,000 for taxpayers with an AFS. The term AFS is defined later in this section. Therefore, if the accounting procedure sets a threshold that exceeds $500 ($5,000 for taxpayers with an AFS), only the items that cost $500 ($5,000) or less qualify for the safe harbor.

If the taxpayer’s accounting procedure treats the cost of items that have a useful life of 12 months or less as a current deduction, the procedure can, but does not have to, also set a dollar limit on those items. The dollar limit could be greater than the $500 or $5,000 safe harbor limit. However, even though the taxpayer’s 12-months-or-less accounting procedure treats the cost of an item as a current deduction, the cost qualifies for the safe harbor only if the item costs $500 ($5,000) or less.

In other words, an ordinary and necessary business expense must meet two requirements to qualify for the de minimis safe harbor:

1. It must be currently deductible under the taxpayer’s accounting procedure that was in place at the beginning of the tax year. That means it must be within one or both of two limits:
   a. A de minimis amount (which can be greater than the $500 or $5,000 limit for the safe harbor), and
The taxpayer must have an invoice to deduct an expense under the de minimis safe harbor. For example, if a taxpayer purchases appliances along with the purchase of real property, and the price for each appliance is less than $500, the taxpayer cannot deduct the appliances under the de minimis safe harbor unless the seller gives the taxpayer an invoice for the purchase of the appliances.

Example 10.34 De Minimis Safe Harbor Applied to Materials and Supplies

Abacus Accounting’s financial accounting procedures require the firm to treat items that cost $500 or less as an expense for nontax purposes. Abacus purchased 1,000 calculators that cost $100 each for use in its business. Each calculator is expected to have an economic useful life of more than 12 months, and Abacus reasonably expects to use most of the calculators within a year after the purchase.

Because each calculator is a unit of property that costs $200 or less, the calculators qualify as materials and supplies. In addition, because the cost is under $500, the expenditure is eligible for the de minimis safe harbor election. Abacus is faced with a decision. If Abacus does not elect the de minimis safe harbor, the cost of each calculator is deductible in the tax year the calculator is first used or consumed. However, if Abacus elects the de minimis safe harbor, it must deduct the cost of all of the calculators as an ordinary and necessary business expense because the de minimis safe harbor applies to all amounts paid for qualifying materials and supplies [Treas. Reg. § 1.263(a)-1(f)(3)(ii)].
Qualifications for Election

I.R.C. § 179 Provides Ability to Choose

By contrast, taxpayers may selectively choose specific assets to expense under I.R.C. § 179, and gain or loss on those assets receives I.R.C. § 1231 treatment when sold or exchanged.

However, section 179 deductions are subject to a total annual dollar limit, an investment limit, and a business income limit that do not apply to amounts deducted under the de minimis safe harbor election.

Amounts spent for assets to which the taxpayer’s de minimis safe harbor election applies are not included in the dollar limit or investment limit for the section 179 deduction.

The I.R.C. § 179 limits for 2015 are explained in the “New Legislation” chapter in this book.

Example 10.35 De Minimis Safe Harbor

Rainbow Farm’s financial accounting procedures require Rainbow to treat items that cost $500 or less as an expense for nontax purposes. Rainbow purchased 100 heifers that cost $400 each for use in its farming operation. Each heifer is expected to have an economic useful life of more than 12 months.

Because the cost is under $500, the expenditure is eligible for the de minimis safe harbor. If Rainbow elects the de minimis safe harbor, Rainbow must deduct the cost of all the heifers as an ordinary and necessary business expense in the year it is paid or incurred. The de minimis safe harbor applies to all amounts paid that do not exceed the de minimis safe harbor amount.

Sale of Items Previously Deducted

Property to which a taxpayer applies the de minimis safe harbor is not treated upon sale or other disposition as a capital asset under I.R.C. § 1221 or as property used in the trade or business under I.R.C. § 1231.

Economic Useful Life

The economic useful life of a unit of property is not necessarily its inherent useful life; instead it is the period during which the property may reasonably be expected to be useful in the taxpayer’s trade or business [Treas. Reg. § 1.162-3(c)(4)]. Taxpayers must consider the useful life factors in Treas. Reg. § 1.167(a)-1(b), which include

1. wear and tear and decay or decline from natural causes;
2. economic changes, inventions, and current developments in the industry and the taxpayer’s trade or business;
3. climatic and other local conditions peculiar to the taxpayer’s trade or business; and
4. the taxpayer’s policy on repairs, renewals, and replacements.

Qualifications for Election
Applicable Financial Statement
An AFS (in descending priority) is defined as

1. a financial statement required to be filed with the Securities and Exchange Commission (SEC);

2. a certified audited financial statement that is accompanied by the report of an independent CPA, and that is used for credit purposes; reporting to shareholders, partners, or similar persons; or any other substantial nontax purpose; or

3. a financial statement (other than a tax return) that the taxpayer is required to provide to a federal or state government or an agency other than the SEC or the IRS.

Goal Is to Align Expensing Policies
The IRS's goal is to have taxpayers align their tax and nontax expensing policies. The standards applicable to an AFS should prevent a taxpayer from adopting an accounting procedure that materially distorts income.

The IRS believes that the $500-per-item deduction limit for taxpayers without an AFS and the $5,000-per-item deduction limit for taxpayers with an AFS operate to achieve this result.

Accounting Procedures
A taxpayer’s nontax accounting procedures may set a per item expensing limit that is lower or higher than the allowable safe harbor amount. If an accounting procedure sets a lower limit for financial accounting, that lower limit also applies for tax purposes. If the accounting procedure sets a higher limit, the safe harbor deduction is limited to $500 for taxpayers without an AFS or $5,000 for taxpayers with an AFS.

A taxpayer can set different limits for different types of property in its written accounting procedure and can provide exclusions for specified types of property.

An accounting procedure does not have to specify a cost limit for items with an economic useful life that is 12 months or less. Nonetheless, if the cost of the item is greater than the $500 or $5,000 safe harbor ceiling, the cost must be capitalized and depreciated.

Observation One Accounting Procedure Is Enough
The accounting procedure may, but is not required to, have both a de minimis amount and a useful life that is 12 months-or-less policy. However, if it has only one of them, only items that are included in that accounting provision qualify for the safe harbor.

Figure 10.2 provides a sample written accounting policy. An accounting officer or chief financial officer should sign and date the policy prior to the first day of the applicable tax year. The taxpayer may choose different thresholds for amounts A and B. This sample statement is provided only as a guide for the de minimis safe harbor and is not intended to be a comprehensive capitalization policy and procedure. A taxpayer should adopt the best policy for its business, taking into account all considerations and recommendations from its tax advisers and independent auditors.

If a taxpayer’s financial results are reported on a group AFS, the group’s AFS may be treated as the taxpayer’s AFS, and the group’s written accounting procedures may be treated as the taxpayer’s written accounting procedures [Treas. Reg. § 1.263(a)-1(f)(3)(vi)].

Variable Interest Entities
A small business taxpayer that does not otherwise have an AFS is considered to have an AFS if its financial results are consolidated under the Financial Accounting Standard Board (FASB) Variable Interest Entities (VIE) model in its Accounting Standards Codification (ASC) topic 810. This inclusion allows a VIE to adopt the consolidated group’s written accounting procedures and the corresponding higher $5,000-per-item deduction ceiling under the de minimis safe harbor.
The **name of company** considers a fixed asset to be a tangible asset purchased for use in the day-to-day operations of the company from which an economic benefit will be derived over a period greater than 1 year. Fixed assets include items such as buildings, leasehold improvements, equipment, office furniture, fixtures, computers, and other related technology equipment.

At the time a fixed asset is acquired, its cost is capitalized unless it has a value of \((\text{amount } A)\) or less (including transactional and other costs related to the acquisition), in which case the cost is expensed in the period the asset is acquired.

Additionally, amounts paid for property with an estimated useful life of 12 months or less and with a value of \((\text{amount } B)\) or less are expensed. Management will periodically review these levels and make any modifications as necessary.

This policy was approved by:

__________________________
Name

__________________________
Title

__________________________
Date

---

**Example 10.36 Taxpayer with an AFS**

Office Interiors, Inc. has an AFS and had a written accounting procedure at the beginning of the year that requires Office Interiors to expense amounts paid for any property that costs $5,000 or less. During the year it spent $6,250,000 to purchase 1,250 computers at $5,000 each. Office Interiors received an invoice from its supplier indicating the $6,250,000 total amount due and the $5,000 price per item. Each computer is a separate unit of property. If Office Interiors elects the de minimis safe harbor, it must deduct the $6,250,000 [Treas. Reg. § 1.263(a)-1(f)(7), Example 3].

---

**Example 10.37 Taxpayer with No AFS**

Paula’s Plumbing, LLC does not have an AFS, but its accounting procedures in place at the beginning of the tax year require Paula’s to expense amounts paid for any property that costs $500 or less. Paula’s purchased 10 printers at $250 each. The invoice shows the $2,500 total cost and the $250 price per printer. Each printer is a separate unit of property. Paula’s expensed the total amount paid for the printers on its books and records. If Paula’s Plumbing elects the de minimis safe harbor, it may deduct the $2,500 [Treas. Reg. § 1.263(a)-1(f)(7), Example 1].

---

**Example 10.38 Economic Useful Life**

Arnie’s Auto Repair, LLC does not have an AFS, but its accounting procedures in place at the beginning of the year require Arnie’s to expense amounts paid for any property that costs $300 or less, and to expense the entire cost of any property with an economic useful life of 12 months or less. The business purchased two items that have an economic useful life of 12 months or less: a point-of-service device that cost $400 and a tablet computer that cost $600.

If Arnie’s elected the de minimis safe harbor, Arnie’s may deduct the $400 cost of the point-of-service device because its economic useful life does not exceed 12 months, even though the device’s $400 cost exceeds Arnie’s $300 expensing limit for other property.
However, even though Arnie’s expensed the $600 cost of the tablet for nontax purposes because its economic useful life does not exceed 12 months, Arnie’s cannot deduct the tablet’s cost for tax purposes under the de minimis safe harbor because the cost exceeds the $500 deduction limit for taxpayers without an AFS [Treas. Reg. § 1.263(a)-1(f)(7), Examples 7 and 8].

Arnie’s must capitalize and depreciate the cost of the tablet computer unless the cost meets the general I.R.C. § 162 requirement of not distorting income or qualifies for the section 179 deduction.

---

**Example 10.39 Allocation of Transaction Costs to Property**

Egg Harbor Electronics, Inc. had an AFS and a written accounting procedure in place at the beginning of the year that requires Egg Harbor to expense amounts spent for property that costs less than $5,000. Egg Harbor purchased wireless routers for each of its 10 office locations, for a total price of $45,000, including delivery and installation fees. Each router is a separate unit of property.

The supplier’s invoice shows $45,000 as the total amount due, including a $2,500 price per router ($2,500 × 10 = $25,000) plus $20,000 for delivery and installation costs. Egg Harbor allocates $2,000 ($20,000 ÷ 10) of the delivery and installation costs to each router on a pro rata basis, bringing the cost of each router to $4,500 ($2,500 + $2,000).

If Egg Harbor elects the de minimis safe harbor, it cannot capitalize the $45,000 on its federal income tax return. The $45,000 is deductible as a business expense, provided Egg Harbor also deducts the amount on its AFS [Treas. Reg. § 1.263(a)-1(f)(7), Example 5].

---

**Example 10.40 Noninvoice Additional Costs**

Ralph’s Routers, LLC does not have an AFS, but at the beginning of the tax year it had accounting procedures in place that require Ralph’s to expense amounts paid for property that does not cost more than $500. Ralph’s paid an interior designer $600 to shop, evaluate, and make recommendations for new furniture for its conference room.

After considering the designer’s recommendations, Ralph’s purchased a conference room table for $500 and 10 chairs that cost $300 each. The designer submitted a $600 invoice for its services, and the furniture retailer submitted a separate invoice showing $500 due for the table and $300 due for each chair.
Because the interior designer’s fee was not on the same invoice as the property, Ralph’s is not required to include the interior designer’s charges in determining whether the de minimis safe harbor election applies to the table and each chair. As a result, if Ralph’s elects the safe harbor, Ralph’s can deduct the amounts paid for the table, chairs, and the interior designer’s services for both tax and nontax purposes [Treas. Reg. § 1.263(a)-1(f)(7), Example 6].

**Annual Election**

The de minimis safe harbor election is an annual election affecting only the tax year for which the election is made. To make the election, an eligible taxpayer (anyone with an accounting procedure in place at the beginning of the year that requires expensing items that cost no more than a specified amount or that have a useful life of 12 months or less) must attach a statement to the taxpayer’s timely filed (including extensions) original federal income tax return [Treas. Reg. § 1.263(a)-1(f)(5)]. Once made, the election cannot be revoked for that tax year.

The statement must be titled “Section 1.263(a)-1(f) De Minimis Safe Harbor Election.” It must include the taxpayer’s name, address, taxpayer identification number (TIN), and a statement that the taxpayer is making the de minimis safe harbor election under Treas. Reg. § 1.263(a)-1(f).

The election cannot be made by applying for a change in accounting method (which means that no Form 3115 is required), and (except for the transitional rule explained earlier in this chapter) the election cannot be made on an amended return filed later than the original return’s extended due date without obtaining the IRS’s consent through a letter ruling [see Treas. Reg. §§ 301.9100-2 and 301.9100-3].

An election for an S corporation or partnership must be made by the entity and not by the shareholders or partners. If a consolidated group files a consolidated income tax return, the common parent makes the election for each member of the consolidated group, and the statement must include the names and TINs of each member for which the election is made.

**Figure 10.3** provides an example of the required statement.

If a taxpayer manipulates transactions to achieve a tax benefit or avoid the safe harbor’s limitations (for example, by using separate invoices for components of property that are generally acquired or produced as a single unit of property), the IRS may make appropriate adjustments.

**FIGURE 10.3 De Minimis Safe Harbor Election Statement**

<table>
<thead>
<tr>
<th>Section 1.263(a)-1(f) De Minimis Safe Harbor Election</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ Corporation</td>
</tr>
<tr>
<td>2014 Main Street</td>
</tr>
<tr>
<td>Anywhere, NY 99999</td>
</tr>
</tbody>
</table>

Employer Identification Number: 22-2222222

For the year ending December 31, 2014

XYZ Corporation elects the de minimis safe harbor under Treas. Reg. § 1.263(a)-1(f) for its tax year ending December 31, 2014.
Taxpayers that do not elect the de minimis safe harbor must treat amounts paid for materials and supplies in accordance with the Treas. Reg. § 1.162-3 rules discussed earlier in this chapter.

**ROUTINE MAINTENANCE SAFE HARBOR**  Treas. Reg. § 1.263(a)-3(i)
requires taxpayers to treat costs of performing routine maintenance activities on a unit of property as currently deductible repairs that are not capitalized.

The routine maintenance safe harbor is not elective. Expenses are deductible if they are for ongoing maintenance activities that are required 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 [Treas. Reg. § 1.263(a)-3(i)(1)(i) and (ii)].

Routine maintenance activities include

1. inspecting,
2. cleaning,
3. testing the unit of property, and
4. replacing damaged or worn parts with comparable and commercially available replacement parts.

**Practitioner Note**  Maintenance Performed Shortly after Purchase

The safe harbor does not apply to scheduled maintenance performed shortly after the purchase of used machinery or an existing building. Routine maintenance must be attributable to the taxpayer’s use of the property [Treas. Reg. § 1.263(a)-3(i)(6), Example 4].

**Expectation of Recurring Activity**

The taxpayer may perform routine maintenance any time during the useful life of a unit of property. However, the activities are considered

routine only if, at the time the taxpayer places the unit of property in service, the taxpayer reasonably expects to perform the activities more than once during the property’s class life.

A taxpayer’s expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the class life of the unit of property, if the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service.

To determine whether the maintenance is routine and if the taxpayer’s expectation is reasonable, consider

1. the nature of the recurring activity,
2. industry practice,
3. manufacturers’ recommendations, and
4. the taxpayer’s experience with similar or identical property [Treas. Reg. § 1.263(a)-3(i)(1)(i) and (ii)].

**Practitioner Note**  Unit of Property Class Life Uses ADS

The class life of a unit of property is the alternative depreciation system (ADS) recovery period regardless of whether the property is depreciated under ADS. The depreciation rule for tax-exempt use property subject to a lease does not apply for this safe harbor. If the unit of property is comprised of components with different class lives, the class life of the unit of property is deemed to be the same as the component with the longest class life [Treas. Reg. § 1.263(a)-3(i)(4)].
Buildings and Building Systems

Routine maintenance may be performed any time during the useful life of the building structure or building systems. However, the activities are considered routine only if the taxpayer expects to perform the activities **more than once during a 10-year period** that begins when the taxpayer places the building structure or building system in service.

A taxpayer’s expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the 10-year period, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service. The same factors previously listed are considered to determine whether maintenance is routine and whether a taxpayer’s expectation is reasonable.

**Example 10.41 Routine Maintenance plus Upgrades**

Muddy River Towing, Inc. performs routine maintenance on its towboats’ engines every 4 years. (The class life of the towboats is 18 years.) The cost qualifies for the routine maintenance safe harbor because Muddy River expects to perform the maintenance activity more than once during the property’s class life.

However, when the towboats were due for their second round of routine maintenance, Muddy River decided to upgrade the towboat engines to increase their horsepower and propulsion, which will permit the towboats to tow heavier loads. Accordingly, Muddy River performed many of the same activities that it performs during typical scheduled maintenance (such as cleaning, inspecting, reconditioning, and replacing minor parts), but at the same time Muddy River upgraded certain engine parts to increase the towing capacity in excess of the capacity when Muddy River placed the towboats in service.

Thus, the work done on the engines encompasses more than the recurring activities that Muddy River expected to perform as a result of its use of the towboats, and it did more than keep the towboats in their ordinarily efficient operating condition.

The amount paid to increase the engines’ horsepower and propulsion is for betterments to the towboats, and such amounts are excepted from the routine maintenance safe harbor. In addition, because the scheduled maintenance procedures directly benefit the upgrades, none of the amounts that Muddy River paid for the maintenance and upgrade of the engines qualify for the routine maintenance safe harbor. Muddy River must capitalize the amounts paid for maintenance and upgrades of the engines as an improvement to the towboats [Treas. Reg. § 1.263(a)-3(i)(6), Example 10].

As illustrated in the towboat example, expenditures that result in a betterment or an adaptation of property to a new or different use do not qualify for the routine maintenance safe harbor [Treas. Reg. § 1.263(a)-3(i)(3)]. However, some restorations qualify for the routine maintenance safe harbor. Restorations that do not qualify include bringing deteriorated and nonfunctional property back to an ordinarily operating condition, and the requirement to capitalize the cost of replacement property when claiming a gain or loss on the disposition of a major component.

**Example 10.42 Maintenance for Prior Owner’s Use**

In January 2015 Bell Manufacturing purchased a used machine for use in its manufacturing operations. The machine has an ADS class life of 10 years. Bell placed the machine in service in January 2015, and at that time, Bell expected to perform manufacturer-recommended scheduled maintenance on the machine approximately every 3 years. The scheduled maintenance includes cleaning and oiling the machine; inspection of parts for defects; and replacement of minor items such as springs, bearings, and seals with comparable commercially available replacement parts. At the time Bell purchased the machine, the machine was approaching the end of a 3-year scheduled maintenance period. As a result, in February 2015 Bell performed the manufacturer’s recommended scheduled maintenance [Treas. Reg. § 1.263(a)-3(i)(6), Example 4].

**Question 1.**

Do the amounts paid by Bell in February 2015 qualify for the routine maintenance safe harbor?

**Answer 1.**

No. The costs incurred were primarily as a result of the prior owner’s use of the property and not
Bell’s use. Bell acquired the machine just before it had received its 3-year scheduled maintenance. The amounts paid for scheduled maintenance must be capitalized if those amounts result in a betterment, including the amelioration of a material condition or defect, or otherwise result in an improvement.

**Question 2.**
What if, after paying for the maintenance in 2015, Bell continues to operate the machine and pays for amounts to perform the next scheduled manufacturer-recommended maintenance on the machine in 2018? Do those costs qualify for the routine maintenance safe harbor?

**Answer 2.**
Yes, assuming that the activities performed are scheduled maintenance activities similar to those performed in 2015. Because the scheduled maintenance performed in 2018 involves the recurring activities that Bell performs as a result of its use of the machine, keeps the machine in ordinarily efficient operating condition, and consists of maintenance activities that Bell expects to perform more than once during the 10-year class life of the machine, Bell’s maintenance costs are eligible for the routine maintenance safe harbor. Accordingly, the amounts paid for scheduled maintenance in 2018 are deemed not to improve the machine, and Bell is not required to capitalize those costs [Treas. Reg. § 1.263(a)-3(i)(6), Example 4].

---

**Practitioner Note**

**Costs That Do Not Qualify for Safe Harbor**

Amounts incurred for activities falling outside the routine maintenance safe harbor are not necessarily expenditures required to be capitalized under Treas. Reg. § 1.263(a)-3. Instead they are subject to analysis under the general rules for improvements.

The final regulations illustrate the application of the routine maintenance safe harbor.

**Example 10.43 Escalator System**

Bumble, Inc. acquired a large retail mall in which it leases space to retailers. The mall contains an escalator system with 40 escalators that include landing platforms, trusses, tracks, steps, handrails, and safety brushes. Bumble reasonably estimated that it would need to replace the handrails on the escalators approximately every 4 years to keep the escalator system in its ordinarily efficient operating condition. After a routine inspection and test of the escalator system in year 4, Bumble replaced the handrails with comparable and commercially available handrails.

The escalator system, including the handrails, is a building system. The amounts Bumble paid for the handrail replacements are within the routine maintenance safe harbor because the replacement of the handrails involved recurring activities that Bumble

1. expected to perform as a result of its use of the escalator system to keep the escalator system in an ordinarily efficient operating condition, and

2. reasonably expected to perform more than once during the 10-year period beginning at the time the building system was placed in service.

Accordingly, the amounts paid for the replacement of the handrails in year 4 are deemed not to improve the building unit of property, and Bumble does not have to capitalize those amounts [Treas. Reg. § 1.263(a)-3(i)(6), Example 13].

**Question.**
When Bumble placed its building in service, Bumble reasonably expected that it would need to replace the escalator steps every 18 to 20 years to keep the escalator system in its ordinarily efficient operating condition. If Bumble has to replace the steps in year 9, can Bumble deduct costs incurred to replace the escalator steps even though it had reasonably expected that this replacement would not be needed for several more years?

**Answer.**
Because the replacement of the steps does not involve recurring activities that Bumble expected to perform more than once during the 10-year period beginning at the time the building structure or the building system was placed in service, the costs of these activities do not fall within the routine maintenance safe harbor.

Accordingly, the costs of replacing the steps in year 9 are not eligible for the routine maintenance safe harbor, and they must be capitalized if they result in an improvement to the
building system [Treas. Reg. § 1.263(a)-3(i)(6), Example 14].

Note: If replacing the steps does not result in an improvement to the building system, the cost can still be deducted as a repair. This example is provided only to illustrate the limits of the routine maintenance safe harbor.

Example 10.44 HVAC System
Southern Windows, Inc. expected that every 4 years it would need to perform detailed testing, monitoring, and preventative maintenance on its HVAC system to keep the HVAC system in its ordinarily efficient operating condition. This scheduled maintenance includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the HVAC system and many of its component parts. If inspection or testing discloses a problem with any component, the part is repaired or replaced with a comparable and commercially available replacement part. The scheduled maintenance at 4-year intervals is recommended by the manufacturer of the HVAC system and is routinely performed on similar systems in similar buildings.

In year 4 Southern Windows performed the scheduled maintenance. However, Southern Windows did not perform the scheduled HVAC maintenance again until year 11. Southern Windows’s reasonable expectation that it would perform the maintenance every 4 years will not be deemed unreasonable merely because it did not actually perform the maintenance a second time during the 10-year period, provided that it can substantiate that its expectation was reasonable at the time the property was placed in service.

If Southern Windows can demonstrate that its expectation was reasonable in year 1, then the amounts it paid for the maintenance of the HVAC system in years 4 and 11 are both within the routine maintenance safe harbor [Treas. Reg. § 1.263(a)-3(i)(6), Example 15].

Planning Pointer Need to Document Maintenance Plan
Practitioners should impress on their clients the importance of documenting maintenance program expectations for significant units of property owned or leased by the taxpayer. Supporting documentation can include owner’s manuals or written documentation of a suggested maintenance program provided by a maintenance service provider or the manufacturer. Taxpayers can also use a formal written “preventative maintenance plan” to support a position that certain expenditures qualify under the routine maintenance safe harbor.

Practitioner Note I.R.C. § 263A May Still Apply
Although amounts paid for routine maintenance are generally treated as currently deductible repairs, they may be subject to capitalization under I.R.C. § 263A if the amounts comprise the direct or allocable indirect costs of other property produced by the taxpayer or acquired for resale [Treas. Reg. § 1.263(a)-3(i)(5)].

SMALL TAXPAYER SAFE HARBOR A safe harbor election allows taxpayers with average annual gross receipts of $10,000,000 or less to deduct a limited amount of expenditures for repairs, maintenance, and improvements to qualifying buildings.

Small business taxpayers and rental property owners who elect the Treas. Reg. § 1.263(a)-3(h) safe harbor for an eligible building property are not required to capitalize certain amounts as long as the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities does not exceed the lesser of

1. $10,000, or
2. 2% of the unadjusted basis of the eligible building.

Small Taxpayer Safe Harbor
A qualifying taxpayer who did not make any capital improvements to an eligible building does not need to make this election. However, if the taxpayer did make minor capital improvements, the election permits a current-year deduction rather than requiring the taxpayer to capitalize and depreciate the amount paid for the improvement expenses. The election also protects the taxpayer if an IRS examiner seeks to reclassify as a capital expenditure an amount that the taxpayer treated as a repair or maintenance cost.

### Eligible Building Property

The term *eligible building property* refers to a building, condominium, cooperative, or leased building or portion of a building that has an unadjusted basis of $1,000,000 or less [Treas. Reg. § 1.263(a)(4)].

The unadjusted basis of eligible building property owned by the taxpayer is generally the basis determined under I.R.C. § 1012, without regard to any adjustments described in I.R.C. § 1016(a)(2) or (3) (generally, depreciation, amortization, and depletion) or to amounts that the taxpayer elected to treat as an expense (for example, under I.R.C. § 179) [Treas. Reg. § 1.263(a)-3(h)(5)(i)].

For purposes of this provision, the unadjusted basis of eligible building property leased to the taxpayer is the total amount of (undiscounted) rent the lessee pays or expects to pay under the lease for the entire term of the lease, including renewal periods if all the facts and circumstances in existence during the tax year in which the lease is entered into indicate a reasonable expectancy of renewal [Treas. Reg. § 1.263(a)-3(h)(5)(ii)].

### Safe Harbor Amounts

Amounts paid by the taxpayer for repairs, maintenance, improvements, and similar activities to which the taxpayer properly applies the safe harbor (and for which the taxpayer properly makes the election) are not treated as improvements. The amounts may be deducted under Treas. Reg. § 1.162-1 or 1.212-1, as applicable, in the tax year the amounts are paid, provided the amounts otherwise qualify for a deduction under those regulations [Treas. Reg. § 1.263(a)-3(h)(7)].

However, if the total expenditures for repairs, maintenance, improvements, and similar activities for an eligible building exceed the lesser of $10,000 or 2% of the unadjusted basis of the building, the safe harbor election is not available for that eligible building property. The taxpayer must apply the general improvement rules to determine whether amounts are for improvements to the unit of property. These rules include the safe harbor for routine maintenance and the de minimis safe harbor election [Treas. Reg. § 1.263(a)-3(h)(8)].

### Observation

#### 2% or $10,000 Limit

$10,000 is 2% of $500,000, so if the building’s unadjusted basis exceeds $500,000, the $10,000 amount will always be the lesser amount. If the building’s unadjusted basis is less than $500,000, the 2% limitation will apply because that will be less than $10,000.

Amounts paid for repairs, maintenance, improvements, and similar activities performed on eligible building property include amounts that are not capitalized under the de minimis safe harbor election and amounts that are deemed not to improve property under the safe harbor for routine maintenance [Treas. Reg. § 1.263(a)-3(h)(2)]. Those safe harbors are not limited to $10,000 (or less) of total expenditures, but the amounts deducted under those safe harbors are counted in the $10,000 (or less) limit on expenses incurred for the small taxpayer safe harbor.

### Planning Pointer

#### Future Increases Possible

The IRS can adjust the $10,000, 2%, and $1,000,000 limits through published guidance in the Federal Register or the Internal Revenue Bulletin [Treas. Reg. § 1.263(a)-3(h)(9)].
Qualifying Taxpayer

The term *qualifying taxpayer* means a taxpayer whose average annual gross receipts for the 3 preceding tax years are less than or equal to $10,000,000.

If a taxpayer has been in existence for less than 3 tax years, the taxpayer determines its average annual gross receipts for the number of tax years (including short tax years) that the taxpayer (or its predecessor) has been in existence. If a tax year is less than 12 months (a short taxable year), gross receipts must be annualized by multiplying the gross receipts for the short period by 12 and dividing the product by the number of months in the short period [Treas. Reg. § 1.263(a)-3(h)(3)(ii) and (iii)].

The term *gross receipts* means the taxpayer’s receipts that are properly recognized under the taxpayer’s methods of accounting used for federal income tax purposes. Gross receipts include total sales (net of returns and allowances) and all amounts received for services, plus any income from investments and from incidental or outside sources.

Except to the extent of gain recognized, gross receipts do not include amounts derived from a nonrecognition transaction, and they do not include sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service and the taxpayer merely collects and remits the tax to the taxing authority [Treas. Reg. § 1.263(a)-3(h)(3)(iv)].

**Example 10.45 Safe Harbor Applied by Lessor**

Rita Rentz owns a house that she rents to an individual. **Figure 10.4** shows the rent she collected for the year, the unadjusted basis of the rental property assets, and the cost of the current-year improvements. Rita’s 3-year average annual gross receipts are less than $10,000,000, and she elected no other safe harbors on her tax return. Rita asked her tax practitioner, Paul Preparer, to determine if she can elect the small taxpayer safe harbor. Rita’s expenses do not exceed $10,000, but she must also consider the 2% of unadjusted building basis limit.

**Figure 10.4 Rita’s Rental Property Records**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current-year rent collected</td>
<td>$ 21,360</td>
</tr>
<tr>
<td>Unadjusted basis:</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Building</td>
<td>99,500</td>
</tr>
<tr>
<td>Building improvements in prior years</td>
<td>20,100</td>
</tr>
<tr>
<td>Lawn mower</td>
<td>1,450</td>
</tr>
<tr>
<td>Appliances</td>
<td>1,700</td>
</tr>
<tr>
<td>Total unadjusted basis</td>
<td>$132,750</td>
</tr>
<tr>
<td>Current-year improvements</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Current-year repairs and maintenance</td>
<td>3,275</td>
</tr>
<tr>
<td>Total current-year expenses</td>
<td>$ 5,275</td>
</tr>
</tbody>
</table>

Paul calculates the unadjusted basis of the building by including the basis of the building and improvements made to it in prior years, which total $119,600 ($99,500 + $20,100). Her 2% limit is only $2,392 ($119,600 × 2%). Because Rita’s $5,275 expenses for repairs, maintenance, and improvements in the current year exceed the 2% limit, she is not eligible for the small taxpayer safe harbor election.

Assuming that Rita’s total expenses do not create a loss that would be limited by the I.R.C. § 469 passive loss rules, Rita will be able to deduct the $3,275 of repair and maintenance expenses. She must capitalize and depreciate the $2,000 of improvements over 27.5 years.

**Example 10.46 Safe Harbor Applied by Lessee**

Murray’s Motorcycles, LLC has a 20-year lease for a building in which it operates a retail store. The monthly rent is $4,000. For purposes of the small taxpayer safe harbor, Murray’s unadjusted basis in the building is $960,000 ($4,000 × 12 months × 20 years).

The building is an eligible building property for the small taxpayer safe harbor because its unadjusted basis is $1,000,000 or less. Murray’s limit for current-year repairs, maintenance, and
improvement expenses is $10,000, because that is less than $19,200 (2% × $960,000) [Treas. Reg. § 1.263(a)-3(h)(10), Example 4].

Example 10.47 More Than One Building
Larry Lessor owns two rental properties, each with a $300,000 unadjusted basis. Larry paid $5,000 for repairs and improvements to building A. Because the amount does not exceed the lesser of $10,000 or $6,000 ($300,000 × 2%), Larry may elect to apply the safe harbor to building A, deducting the $5,000 cost of the repairs and the otherwise capitalizable improvements.

Larry paid $7,000 for repairs and improvements to building B. Larry cannot elect the small taxpayer safe harbor for building B because $7,000 exceeds the $6,000 ($300,000 × 2%) limit [Treas. Reg. § 1.263(a)-3(h)(10), Example 3]. The safe harbor is applied building-by-building, so if Larry paid $5,500 for repairs and improvements to building B, Larry can deduct those amounts under the small taxpayer safe harbor.

**Observation** Small Taxpayer Safe Harbor
The final regulations for this safe harbor eliminate the need to separately analyze the building structure and the building systems, as required elsewhere in the improvement rules.

**FIGURE 10.5 Sample Small Taxpayer Safe Harbor Election**

![Sample Small Taxpayer Safe Harbor Election](image)

A taxpayer elects the small taxpayer safe harbor for a building by attaching a statement to the taxpayer’s timely filed original federal tax return (including extensions) for the tax year in which the taxpayer pays for repairs, maintenance, improvements, and similar activities performed on the eligible building property, providing that such amounts qualify under the safe harbor. (Treas. Reg. §§ 301.9100-1 through 301.9100-3 provide rules governing extensions of the time to make regulatory elections.)

The statement must be titled “Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers,” and it must include the taxpayer’s name, address, TIN, and a description of each eligible building property to which the taxpayer is applying the election.

An S corporation or a partnership makes the election at the entity level. The shareholders or partners do not make the election on their individual returns.

An election may not be made by filing an application for change in accounting method (which means that no Form 3115 is required) or, before obtaining the IRS’s consent to make a late election, by filing an amended federal tax return.

The election, once made, cannot be revoked. **Figure 10.5** provides a sample of the small taxpayer safe harbor election that the taxpayer must attach to his or her federal income tax return each year that he or she elects the safe harbor.
Election to Capitalize Repair and Maintenance Costs

A business can elect to capitalize amounts paid for repairs and maintenance if the business also capitalizes the expenditures on its books and records. Treas. Reg. § 1.263(a)-3(n) allows a taxpayer to elect to treat amounts paid during the tax year for repairs and maintenance (as defined under Treas. Reg. § 1.162-4) to tangible property as amounts paid to improve that property and as an asset subject to the allowance for depreciation. This election is called the book conformity election because it allows the taxpayer to conform its tax deductions to its financial accounting procedure that capitalizes amounts paid for repairs and maintenance. To make the election, the taxpayer must incur the amounts in carrying on the taxpayer’s trade or business, and the taxpayer must treat the amounts as capital expenses on its books and records regularly used in computing income.

The election applies to all amounts paid or incurred for repairs and maintenance of tangible property that are capitalized on the taxpayer’s books and records for the tax year covered by the election. As a result, these amounts are not treated as amounts paid for repairs and maintenance and are not currently deductible.

A taxpayer who capitalizes repair and maintenance costs under the election is still eligible to apply the de minimis safe harbor, the safe harbor for small taxpayers, and the routine maintenance safe harbor to repair and maintenance costs that are not treated as capital expenses on the taxpayer’s books and records.

A taxpayer makes the capitalization election by attaching a statement to the taxpayer’s timely filed original federal tax return (including extensions) for the tax year in which the taxpayer pays amounts for repairs and maintenance. The statement must be titled “Section 1.263(a)-3(n) Election” and must include the taxpayer’s name, address, TIN, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under Treas. Reg. § 1.263(a)-3(n). Figure 10.6 shows a sample election statement.

If a consolidated group files a consolidated income tax return, the common parent makes the election for each member of the group, and the statement must also include the names and TINs of each member for which the election is made.

An S corporation or a partnership makes the election at the entity level. The shareholders or partners do not make the election on their individual returns.

Taxpayers cannot make the election by filing an application for a change in accounting method (which means that Form 3115 is not required). They must obtain the IRS’s consent to make a late election before making the election by filing an amended federal tax return.
Depreciation Begins When Placed in Service

A taxpayer making this election must treat any amounts paid for repairs and maintenance during the tax year that are capitalized on the taxpayer’s books and records as improvements to tangible property. The taxpayer must begin to depreciate the cost of such improvements when the taxpayer places them in service.

IRS Cannot Challenge Treatment

The election is in effect a safe harbor for taxpayers because the IRS cannot challenge an electing taxpayer’s characterization of a repair expense as a capitalized improvement. If a taxpayer capitalizes repair expenses without making this election, the taxpayer has technically adopted an improper accounting method.

Option Avoids Complex Analysis

Electing to capitalize repairs and maintenance expenses lets taxpayers avoid the sometimes complicated analysis that is necessary to determine whether an expense is a currently deductible repair expense or a capital improvement expenditure.

CHANGE IN ACCOUNTING METHOD

A new revenue procedure allows small business taxpayers to receive automatic consent for certain changes in accounting methods to comply with the final regulations, without filing Form 3115.

The guidance issued by the IRS is complex and has led to uncertainty regarding whether a taxpayer must file Form 3115, Application for Change in Accounting Method. IRS guidance states that adopting the final regulations on a prospective basis does not require filing Form 3115.

Small Business Taxpayers

Treas. Reg. § 1.446(e) generally requires all taxpayers to file Form 3115, Application for Change in Accounting Method, to secure consent from
the IRS to certain changes in accounting methods under the final tangible property regulations.

In conjunction with the issuance of the final tangible property regulations, the IRS issued procedures to follow in making the accounting method changes to comply with the final tangible property regulations. On January 24, 2014, the IRS issued Rev. Proc. 2014-16, 2014-9 I.R.B. 606, which provides the rules for changes in accounting methods to comply with the final tangible property regulations. On September 18, 2014, the IRS issued Rev. Proc. 2014-54, 2014-41 I.R.B. 625, which provides the rules for changes in accounting methods to comply with the final disposition regulations. Additionally, on January 16, 2015, the IRS issued Rev. Proc. 2015-13, 2015-5 I.R.B. 419, and Rev. Proc. 2015-14, 2015-5 I.R.B. 450, with the primary purpose of merging the automatic and nonautomatic accounting method change procedures and compiling all of the automatic method changes issued since 2011.

In an effort to ease the administrative burdens faced by small business taxpayers in applying the final tangible property regulations, on February 13, 2015, the IRS issued Rev. Proc. 2015-20, 2015-9 I.R.B. 694, which provides exceptions to the procedures originally provided in Rev. Proc. 2014-16 and Rev. Proc. 2014-54. Specifically, Rev. Proc. 2015-20 modifies the procedures in Rev. Proc. 2015-14 and Rev. Proc. 2014-54 and allows a small business taxpayer, defined as a trade or business with total assets of less than $10,000,000, or average annual gross receipts of $10,000,000 or less for the prior 3 tax years, to adopt the final regulations without filing Form 3115 for its first year that begins on or after January 1, 2014. The taxpayer does not have to attach a disclosure or statement to the income tax return.

Section 481(a) Adjustment

Generally, a section 481(a) adjustment is required with a change of accounting method to comply with the final regulations. Many of the provisions in the final regulations require the computation of a cumulative section 481(a) adjustment, which effectively makes the provisions in the final regulations retroactive.


Form 3115 Deemed Filed for 2014

A taxpayer who meets the definition of a “small business taxpayer” under Rev. Proc. 2015-20, and who did not file a Form 3115 with its 2014 income tax return, is deemed to have filed Form 3115 electing to apply the final tangible property regulations prospectively (on a cutoff basis), effective January 1, 2014. As a result, the I.R.C. § 481(a) adjustment is deemed to be zero.

Separate Trade or Business

If a taxpayer has more than one separate and distinct trade or business, the taxpayer meets the definition of a small business taxpayer and is eligible for the Form 3115 filing exception under Rev. Proc. 2015-20 if the taxpayer’s trade or business has total assets of less than $10,000,000 or average annual gross receipts of $10,000,000 or less for the prior 3 tax years. Related parties are not required to aggregate their total assets or annual gross receipts in determining eligibility for the exception under Rev. Proc. 2015-20.

When calculating the taxpayer’s total assets to determine if the taxpayer meets the less-than-$10,000,000 requirement, total assets are determined using the accounting method the taxpayer regularly uses in keeping its books and records for its trade or business at the end of the tax year. Gross receipts for each tax year are generally the trade or business’s gross receipts as recognized under its method of accounting for federal income tax purposes.
Multiple Forms 3115 May Be Required

Taxpayers that report multiple trades or businesses on their tax returns (e.g., multiple Schedules C or F (Form 1040)) must file Form 3115 for each trade or business. In addition, taxpayers that report multiple trades or businesses in separate legal entities (e.g., multiple rental properties that are in separate LLCs) must file Form 3115 for each entity.

Separate Set of Books Required

Treas. Reg. § 1.466-1(d) states that a taxpayer with two or more separate trades or businesses can use a different accounting method for each business, as long as it clearly reflects income and a separate set of books and records is kept for each trade or business.

Consequences of Deemed Filing of Form 3115 under Rev. Proc. 2015-20

The following accounting method changes, if applicable, are included in the deemed filing of Form 3115 for small business taxpayers under Rev. Proc. 2015-20:

1. Change number 184: To deduct amounts for repairs and maintenance or to capitalize amounts for improvements to tangible property and, if desirable, change to depreciating under I.R.C. § 167 or I.R.C. § 168 (Includes a change, if any, in the method of identifying the unit of property, or in the case of a building, identifying the building structure or building systems)

2. Change number 185: A change to a regulatory method of accounting

3. Change number 186: A change in method of accounting to deducting nonincidental materials and supplies when paid or consumed

4. Change number 187: A change in method of accounting to deduct incidental materials and supplies when paid or incurred
5. Change number 188: A change in method of accounting to deduct nonincidental rotatable and temporary spare parts when disposed of
6. Change number 189: A change in method of accounting to the optional method for rotatable and temporary spare parts
7. Change number 190: A change in method of accounting by a dealer in property to deduct commissions and other transaction costs that facilitate the sale of property
8. Change number 191: A change in method of accounting by a non–dealer in property to capitalize commissions and other costs that facilitate the sale of property
9. Change number 192: A change in method of accounting to capitalize acquisition or production costs and, if depreciable, depreciating under I.R.C. § 167 or I.R.C. § 168 (Includes capitalizing inherently facilitative amounts allocable to real or personal property even if the property is not eventually acquired)
10. Change number 193: A change in method of accounting to deduct certain costs for investigating or pursuing the acquisition of real property
11. Change number 205: A change in method of accounting for dispositions of a building or structural component. Typically used when an event listed under Treas. Reg. § 1.168(i)-8(d)(1) occurs (e.g., a casualty or like-kind exchange)
12. Change number 206: A change in method of accounting for dispositions of property other than a building or structural component

The following are not included in a deemed filing of Form 3115 under Rev. Proc. 2015:

1. Change number 7: A change from an impermissible method to a permissible method of accounting allowed under Treas. Reg. § 1.446-1(e)(2)(ii)(d), and for depreciable property owned at the beginning of the year of change (e.g., class lives and bonus depreciation)
2. Change number 21: A change in method of accounting for the treatment of removal costs for a disposal of a depreciable asset
3. Change number 196: A change in method of accounting to make a late partial disposition election for a portion of an asset (Used for most dispositions of a building or structural component)
4. Change number 199: A change in method of accounting to comply with Treas. Reg. § 1.167(a)-4 for leasehold improvements in which the taxpayer has a depreciable interest at the beginning of the year of change (e.g., depreciating leasehold improvements over the life of the tenancy)
5. Change number 200: Change(s) in method of accounting from a permissible to permissible MACRS depreciation method(s). Generally applies to general asset accounts (GAAs), single-asset accounts, or multiple asset accounts; and to dispositions of property not in a GAA. Includes a change in method of determining the unadjusted basis of the disposed portion of an asset from one reasonable method to another
6. Audit protection (discussed next)

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**No Clear Record of Change in Accounting**

Rev. Proc. 2015-20, § 2.06, states the following: “While some small business taxpayers may choose to file a Form 3115 in order to retain a clear record of a change in method of accounting or to make permissible concurrent automatic changes on the same form, other small business taxpayers may prefer the administrative convenience of being able to comply with the final tangible property regulations in their first taxable year that begins on or after January 1, 2014, solely through the filing of a federal tax return.” Consequently, a taxpayer who did not file a 2014 Form 3115 does not have a clear record of a change in accounting method.

**Audit Protection**

Rev. Proc. 2015-20, § 2.08, states that a small business taxpayer who chooses to make a section 481(a) adjustment that takes into account only amounts paid or incurred, and dispositions in tax years beginning on or after January 1, 2014, does not receive audit protection under Rev. Proc. 2015-13, § 8.03, for tax years beginning prior to January 1, 2014. This restriction also applies to changes that would have applied under Rev. Proc. 2015-14 and the treatment of dispositions of property. If a small business taxpayer chooses...
to make a section 481(a) adjustment that does not take into account dispositions in tax years beginning before January 1, 2014, then the taxpayer must consistently apply this treatment to all dispositions (except dispositions in GAAs) covered by Rev. Proc. 2015-14, §§ 6.37 through 6.39. Consequently, only dispositions in tax years beginning on or after January 1, 2014, are afforded audit protection.

**Observation** Application of Audit Protection

By filing a 2014 Form 3115, the taxpayer is granted audit and ruling protection for all items and expenditures, not just those that were included in the calculation of the section 481(a) adjustment.

### Potential Missed Opportunities

A deemed filing of Form 3115 under Rev. Proc. 2015-20 presents the following six missed opportunities and related issues:

1. Although a taxpayer will not have to “clean” its depreciation schedule(s), the taxpayer is still required under the repair regulations to
   a. determine its applicable unit of property;
   b. implement accounting procedures for transactions beginning on and after January 1, 2014, under the appropriate tests for betterments, adaptations, restorations, and improvements, as outlined in the repair regulations; and
   c. understand and properly employ the routine maintenance safe harbor and properly determine the class lives of assets capitalized.

2. A taxpayer will be unable to deduct removal costs unless the taxpayer files Form 3115 to adopt accounting method change number 21, even if Form 3115 is filed in a tax year after 2014.

3. A taxpayer will default to what the IRS defines as the taxpayer’s unit of property.
Typical Method Changes Included in a Form 3115 Filing

Taxpayers (including small business taxpayers) who file their own 2014 Form 3115 should, at a minimum, report the following accounting method changes:

1. Change number 184: To deduct amounts for repairs and maintenance or to capitalize amounts for improvements to tangible property, and if desirable, to change to depreciating under I.R.C. § 167 or I.R.C. § 168 (Includes a change, if any, in the method of depreciation).

Advantages of Defining Unit(s) of Property

A taxpayer who owns real estate has a significant advantage when the taxpayer defines its units of property. An IRS agent cannot arbitrarily enforce another definition during a tax examination. The definition of a unit of property affects the characterization of an expense as a deductible repair, and not an improvement, and typically the larger the unit of property, the more likely it is that the expense will be a repair. Definition of a unit of property also establishes the class life of the property, which impacts the taxpayer’s ability to use the routine maintenance safe harbor.

4. A taxpayer will be unable to solve its impermissible depreciation methods without filing Form 3115 with accounting method change number 7.
5. A taxpayer will be unable to get a 4-year spread on a positive (unfavorable) section 481(a) adjustment.
6. A taxpayer will be unable to remove fully depreciated assets that never should have been capitalized under the repair regulations. When those assets are sold, the taxpayer will incur depreciation recapture under I.R.C. § 1245 or I.R.C. § 1250. No depreciation recapture is necessary if the taxpayer files Form 3115.

Any other taxpayer, including small business taxpayers meeting the definition of the term under Rev. Proc. 2015-20, should file a 2014 Form 3115 to take advantage of these opportunities, if applicable.

Taxpayers who fall under the following categories should consider accepting the deemed filing of a 2014 Form 3115:

1. A taxpayer who has no assets or improvements to assets and no significant repairs and maintenance deductions
2. Tax-exempt organizations that are not required to file Form 990-T
3. A taxpayer who leases real property under triple net leases and has not improved the real property after its purchase or construction
4. A taxpayer who only owns land
5. A taxpayer who has significant net operating losses
6. A taxpayer who started a business in 2014
7. A taxpayer who elected bonus depreciation or the section 179 deduction, performed no repairs, and does not own real property
8. A taxpayer who files a Schedule C or Schedule F (Form 1040) with minimal fixed assets, such as office furniture or computers, has no significant repair and maintenance deductions, and rents its office space
9. A taxpayer who files a Schedule E (Form 1040) with no prior improvement expenditures

Indemnifications from Clients

Tax practitioners should highly consider advising their clients to file Form(s) 3115 with a zero section 481(a) adjustment for the 2014 tax year. At a minimum, practitioners should obtain a written acknowledgement that the client (not the practitioner) waived its right to formally file a 2014 Form 3115. Tax practitioners should also consider obtaining written indemnifications from their clients if the taxpayer does not follow the practitioner’s recommendation to formally file a 2014 Form 3115.

The acknowledgment and the indemnification should clearly describe the opportunities that the taxpayer may be waiving by not formally filing a 2014 Form 3115, including significant negative (favorable) section 481(a) adjustments, preclusion of certain IRS audit adjustments, and avoidance of additional tax due because of depreciation recapture on an asset or business that was sold.
identifying the unit of property, or in the case of a building, identifying the building structure or building systems

2. Change number 186: A change in method of accounting to deducting nonincidental materials and supplies when used or consumed

3. Change number 192: A change in method of accounting to capitalize acquisition or production costs, and if depreciable, depreciating under I.R.C. § 167 or I.R.C. § 168 (Includes capitalizing inherently facilitative amounts allocable to real or personal property even if the property is not eventually acquired)

If a taxpayer had prior-year partial dispositions, then the taxpayer should include the following:

1. Change number 205: A change in method of accounting for disposals of a building or structural component (Typically used when an event listed under Treas. Reg. § 1.168(i)-8(d)(1) occurs (e.g., a casualty or like-kind exchange))

2. Change number 206: A change in method of accounting for disposals of property other than a building or structural component

The following are automatic accounting method changes, even if they are filed by the taxpayer in any tax year after tax year 2014:

1. Change number 7: A change from an impermissible method to a permissible method of accounting allowed under Treas. Reg. § 1.446-1(e)(2)(ii)(d), and for depreciable property owned at the beginning of the year of change (e.g., class lives and bonus depreciation)

2. Change number 21: A change in method of accounting for the treatment of removal costs in an entire disposal or partial disposal of a depreciable asset

Depending on the taxpayer’s facts and circumstances, the taxpayer may have to include additional accounting method changes on Form 3115.

**Completing Form 3115**

Taxpayers who do not meet the small business taxpayer exception in Rev. Proc. 2015-20 must file Form 3115, Application for Change in Accounting Method, if IRS consent is required for a change in accounting method. Rev. Proc. 2014-16 provides a simplified filing requirement for taxpayers with 3-year average annual gross receipts of $10,000,000 or less. Qualifying taxpayers are required to complete only part of Form 3115. The following list from Rev. Proc. 2014-16 refers to line numbers on the 2009 revision of the Form 3115. The line numbers in brackets are the equivalent line numbers on the 2015 draft Form 3115.

1. The identification section of page 1 (above Part I)
2. The signature section at the bottom of page 1
3. Part I, line 1(a)
4. Part II, all lines except lines 11 [13], 13 [15a], 14 [17], 15 [none], and 17 [19a]
5. Part II, line 13 [15a], if the change is to depreciating property
6. Part IV, lines 25 [26] and 26 [27]
7. Schedule E—Change in Depreciation or Amortization, if applicable

**Cross-reference**

Form 3115 Filed for Depreciation Errors


**Observation**

Related Parties Disclosure

Line 9 of Form 3115 requires a taxpayer to disclose what accounting method changes its related parties are filing, if any. This information must be included with Form 3115 or on a separately attached schedule.

On line 12 of Form 3115 (line 14 of the 2015 draft Form 3115), the taxpayer must include a detailed description of its present and proposed accounting methods. Rev. Proc. 2014-16 requires taxpayers to cite the specific portion of the repair regulations describing the method to which the taxpayer is changing. For example, a taxpayer...
Completing Form 3115

New Short Form 3115 Coming?

The language of section 3.07 of Rev. Proc. 2015-13 indicates that there will be a new Form 3115 and a new “short Form 3115.” The IRS defines the term Form 3115 as the Form 3115 most recently issued by the IRS or, when permitted in the applicable section of the list of automatic changes, a short Form 3115, and any related attachments. Tax practitioners should visit www.irs.gov to obtain the most recently issued Form 3115.

Concurrent Automatic Changes

A taxpayer who wants to make two or more changes in methods of accounting pursuant to the new rules should file a single Form 3115 for all of the changes, and enter the designated automatic accounting method change numbers for all of the changes on the appropriate line on Form 3115. The taxpayer must include on Form 3115, Part IV, line 25 (line 26 of the 2015 draft Form 3115), the total section 481(a) adjustment for each change in method of accounting being made. If the taxpayer is making more than one change in method of accounting under the final tangible property regulations, the taxpayer must include on an attachment to Form 3115 the amount of the section 481(a) adjustment for each change in method of accounting [Rev. Proc. 2014-16, 2014-9 I.R.B. 606, § 3.02(6)(c)].

The IRS has provided additional guidance to taxpayers filing Form 3115 with more than one automatic accounting method change. Specific steps are as follows:

1. Check the box marked “Other” in the section directly above Part I, where it reads “Check the appropriate box to indicate the type of accounting method change being requested,” and enter “Multi Auto Chng Rqst” on the dotted line. This will identify the reporting of multiple designated automatic accounting method change numbers entered on one Form 3115.

2. To report the applicable designated automatic accounting change numbers for the request on line 1 of Part I, skip line 1(a) and check box 1(b), “Other.” List the designated automatic method change numbers on line 1(b) in the “Description” field.

Net negative (favorable) adjustments are taken into account in a single tax year, and net positive (unfavorable) adjustments are taken into account over 4 tax years.

Signing and Filing Form 3115

A taxpayer must prepare two separate Form 3115 filings. The Ogden office copy must be filed with the IRS at Internal Revenue Service, 1973 Rulon White Blvd., Mail Stop 4917, Ogden, Utah 84201-1000.

The Ogden office copy of Form 3115 must be signed by the taxpayer, or on behalf of the taxpayer by an individual who has personal knowledge of the facts of, and authority to bind the taxpayer requesting the change in accounting method. If the taxpayer is a member of a consolidated group, the Form 3115 submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent with personal knowledge of the facts and circumstances of, and authority to bind, the taxpayer in such matters. Furthermore, if the individual compensated for preparing Form 3115 is not the taxpayer or an individual with the authority to sign Form 3115 on behalf of the taxpayer, the preparer must also sign Form 3115.
1. file a timely original federal income tax return (including extensions) for the year of the change;
2. file an amended tax return within the 6-month extension period implementing the requested change in accounting method for the year of change;
3. attach the original copy of Form 3115 to the amended tax return;
4. file a signed Ogden office copy of Form 3115 with the IRS in Ogden, Utah, no later than the date the original copy of Form 3115 is filed with the amended tax return;
5. provide a signed original copy of Form 3115 to an examining agent, appeals officer(s), or all counsel of the government, if applicable, as required by section 6.03(3); and
6. attach a statement to the Form 3115 that Form 3115 is being “FILED PURSUANT TO § 301.9100-2(b) OF THE PROCEDURE AND ADMINISTRATION REGULATIONS.”

Rev. Proc. 2015-13 clarifies the filing and signature requirements for the original copy of Form 3115, which is filed with the taxpayer’s tax return. An electronic version of the original copy of Form 3115 can be attached to the taxpayer’s timely filed original income tax return, including extensions, implementing the requested automatic accounting method change(s) for the applicable year of the change.

Rev. Proc. 2015-14 does not mention or provide a definition of electronic version. The updated instructions for IRS Form 8878, IRS e-file Signature Authorization for Form 4868 or Form 2350, and the Instructions for Form 8879, IRS e-file Signature Authorization, state that an electronic return originator may use the e-file signature authorization provided by the taxpayer as authority to input the taxpayer’s PIN if the information on the electronic version of the tax return (including Form 3115) agrees with the entries on the paper return.

Rev. Proc. 2015-13, § 6.03(4)(a), provides an automatic 6-month extension of time to file Form 3115. The taxpayer must file Form 3115 within 6 months of the due date (excluding extensions) of the federal income tax return. In addition, the taxpayer must

**Extension of Time to File Form 3115**

The taxpayer must maintain adequate accounting books and records for the year of the change and subsequent tax years to support the accounting method change for which consent was granted. Accounting records include the taxpayer’s regular books of account and such other records and data as may be necessary to support the entries on the books of account and on the tax return (including Form 3115).

**Sample Form 3115**

*Figure 10.8* is a filled-in sample Form 3115 for small business taxpayer choosing to formally file accounting method changes with a zero section 481(a) adjustment. *Figure 10.9* is the attachment for the sample Form 3115.
**FIGURE 10.8 Sample Form 3115**

**Application for Change in Accounting Method**

<table>
<thead>
<tr>
<th>Identification number (see instructions)</th>
<th>OMB No. 1545-0152</th>
</tr>
</thead>
<tbody>
<tr>
<td>12-3456789</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Principal business activity code number (see instructions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>541990</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax year of change begins (MM/DD/YYYY)</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/01/2014</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax year of change ends (MM/DD/YYYY)</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2014</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name of contact person (see instructions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bob Doe</td>
</tr>
</tbody>
</table>

**Check the box to indicate the type of applicant.**

- [ ] Individual
- [ ] Corporation
- [ ] Controlled foreign corporation (Sec. 957)
- [ ] 10/50 corporation (Sec. 904(d)(2)(E))
- [ ] Qualified personal service corporation (Sec. 448(d)(2))
- [ ] Exempt organization. Enter Code section ▶
- [ ] Cooperative (Sec. 1381)
- [ ] Partnership
- [ ] S corporation
- [ ] Insurance co. (Sec. 816(a))
- [ ] Insurance co. (Sec. 831)
- [ ] Other (specify) ▶

**Check the appropriate box to indicate the type of accounting method change being requested.**

- [ ] Depreciation or Amortization
- [ ] Financial Products and/or Financial Activities of Financial Institutions
- [ ] Other (specify) ▶
- [ ] Multi Auto Chng Reqst

**Caution.** To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer to or the taxpayer's requested change in method of accounting. This includes all information requested in this form 3115 (including its instructions), as well as any other information that is not specifically requested.

The taxpayer must attach all applicable supplemental statements requested throughout this form.

**Part I - Information For Automatic Change Request**

1. Enter the applicable designated automatic accounting method change number for the requested automatic change. Enter only one designated automatic accounting method change number, except as provided for in guidance published by the IRS. If the requested change has no designated automatic accounting method change number, check "Other," and provide both a description of the change and citation of the IRS guidance providing the automatic change. See instructions.

   - (a) Change No. ______________
   - (b) Other □ Description ▶ 184, 186, 192

2. Do any of the scope limitations described in section 4.02 of Rev. Proc. 2008-52 cause automatic consent to be unavailable for the applicant’s requested change? If “Yes,” attach an explanation. ▶

**Note.** Complete Part II below and then Part IV, and also Schedules A through E of this form (if applicable).

**Part II - Information For All Requests**

3. Did or will the applicant cease to engage in the trade or business to which the requested change relates, or terminate its existence, in the tax year of change (see instructions)? ▶

   - If “Yes,” the applicant is not eligible to make the change under automatic change request procedures.

4a. Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) under examination (see instructions)? ▶

   - If “No,” go to line 5.

b. Is the method of accounting the applicant is requesting to change an issue (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) either (i) under consideration or (ii) placed in suspense (see instructions)? ▶

**Signature (see instructions)**

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Signature: [John Owner]

Name and title (print or type): [Preparer (other than filer/applicant)]

Signature: [Bob Doe]

Name and title (print or type): [Name of individual preparing the application]

[Name of firm preparing the application]

For Privacy Act and Paperwork Reduction Act Notice, see the instructions.

Sample Form 3115 397
**Form 3115 (Rev. 12-2009)**

**SAMPLE COMPANY, LLC**

**12-3456789**

<table>
<thead>
<tr>
<th>Part II</th>
<th>Information For All Requests (continued)</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>4c</td>
<td>Is the method of accounting the applicant is requesting to change an issue pending (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) for any tax year under examination (see instructions)?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>d</td>
<td>Is the request to change the method of accounting being filed under the procedures requiring that the operating division director consent to the filing of the request (see instructions)?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>If &quot;Yes,&quot; attach the consent statement from the director.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>e</td>
<td>Is the request to change the method of accounting filed under the 90-day or 120-day window period?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>If &quot;Yes,&quot; check the box for the applicable window period and attach the required statement (see instructions).</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>90 day</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>120 day: Date examination ended</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>f</td>
<td>If you answered &quot;Yes&quot; to line 4a, enter the name and telephone number of the examining agent and the tax year(s) under examination.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>Name</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>Telephone number</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>Tax year(s)</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>g</td>
<td>Has a copy of this Form 3115 been provided to the examining agent identified on line 4f?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>5a</td>
<td>Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) before Appeals and/or a Federal court?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>If &quot;Yes,&quot; enter the name of the (check the box)</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>Appeals officer and/or</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>counsel for the government, telephone number, and the tax year(s) before Appeals and/or a Federal court.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>Name</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>Telephone number</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>Tax year(s)</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>b</td>
<td>Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 5a?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>c</td>
<td>Is the method of accounting the applicant is requesting to change an issue under consideration by Appeals and/or a Federal court (for either the applicant or any present or former consolidated group in which the applicant was a member for the tax year(s) the applicant was a member) (see instructions)?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>If &quot;Yes,&quot; attach an explanation.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>6d</td>
<td>If the applicant answered &quot;Yes&quot; to line 4a and/or 5a with respect to any present or former consolidated group, attach a statement that provides each parent corporation’s (a) name, (b) identification number, (c) address, and (d) tax year(s) during which the applicant was a member that is under examination, before an Appeals office, and/or before a Federal court.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>7</td>
<td>If, for federal income tax purposes, the applicant is either an entity (including a limited liability company) treated as a partnership or an S corporation, is it requesting a change from a method of accounting that is an issue under consideration in an examination, before Appeals, or before a Federal court, with respect to a Federal income tax return of a partner, member, or shareholder of that entity?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>If &quot;Yes,&quot; the applicant is not eligible to make the change.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>8a</td>
<td>Does the applicable revenue procedure (advance consent or automatic consent) state that the applicant does not receive audit protection for the requested change (see instructions)?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>b</td>
<td>If &quot;Yes,&quot; attach an explanation.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>9a</td>
<td>Has the applicant, its predecessor, or a related party requested or made (under either an automatic change procedure or a procedure requiring advance consent) a change in method of accounting within the past 5 years (including the year of the requested change)?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>b</td>
<td>If &quot;Yes,&quot; for each trade or business, attach a description of each requested change in method of accounting (including the tax year of change) and state whether the applicant received consent.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>c</td>
<td>If any application was withdrawn, not perfected, or denied, or if a Consent Agreement granting a change was not signed and/or not made in the requested year of change, attach an explanation.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>10a</td>
<td>Does the applicant, its predecessor, or a related party currently have pending any request (including any concurrently filed request) for a private letter ruling, change in method of accounting, or technical advice?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>b</td>
<td>If &quot;Yes,&quot; for each request attach a statement providing the name(s) of the taxpayer, identification number(s), the type of request (private letter ruling, change in method of accounting, or technical advice), and the specific issue(s) in the request(s).</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td>11</td>
<td>Is the applicant requesting to change its overall method of accounting?</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
<tr>
<td></td>
<td>If &quot;Yes,&quot; check the appropriate boxes below to indicate the applicant's present and proposed methods of accounting. Also, complete Schedule A on page 4 of this form.</td>
<td>![ ]</td>
<td>![ ]</td>
</tr>
</tbody>
</table>

**Present method:**

- [ ] Cash
- [ ] Accrual
- [ ] Hybrid (attach description)

**Proposed method:**

- [ ] Cash
- [ ] Accrual
- [ ] Hybrid (attach description)
FIGURE 10.8 Sample Form 3115 (Continued)

Part II  Information For All Requests (continued)

12 If the applicant is either (i) not changing its overall method of accounting, or (ii) is changing its overall method of accounting and also changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following:  
   a. The item(s) being changed.  
   b. The applicant's present method for the item(s) being changed.  
   c. The applicant's proposed method for the item(s) being changed.  
   d. The applicant's present overall method of accounting (cash, accrual, or hybrid).  

13 Attach a detailed and complete description of the applicant's trade(s) or business(es), and the principal business activity code for each. If the applicant has more than one trade or business as defined in Regulations section 1.446-1(d), describe whether each trade or business is accounted for separately; the goods and services provided by each trade or business, and any other types of activities engaged in that generate gross income; the overall method of accounting for each trade or business; and which trade or business is requesting to change its accounting method as part of this application or a separate application.  

14 Will the proposed method of accounting be used for the applicant's books and records and financial statements?  
   For insurance companies, see the instructions.  
   If "No," attach an explanation.  

15a Has the applicant engaged, or will it engage, in a transaction to which section 381(a) applies (e.g., a reorganization, merger, or liquidation) during the proposed tax year of change determined without regard to any potential closing of the year under section 381(b)(1)?  

   b If "Yes," for the items of income and expense that are the subject of this application, attach a statement identifying the methods of accounting used by the parties to the section 381(a) transaction immediately before the date of distribution or transfer and the method(s) that would be required by section 381(c)(4) or (c)(5) absent consent to the change(s) requested in this application.  

16 Does the applicant request a conference with the IRS National Office if the IRS proposes an adverse response?  

17 If the applicant is changing to either the overall cash method, an overall accrual method, or is changing its method of accounting for any property subject to section 263A, any long-term contract subject to section 460, or inventories subject to section 474, enter the applicant's gross receipts for the 3 tax years preceding the tax year of change.  

<table>
<thead>
<tr>
<th>1st preceding year ended: mo. N/A yr.</th>
<th>2nd preceding year ended: mo. N/A yr.</th>
<th>3rd preceding year ended: mo. N/A yr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

Part IV  Section 481(a) Adjustment

24 Does the applicable revenue procedure, revenue ruling, notice, regulation, or other published guidance require the applicant to implement the requested change in method of accounting on a cut-off basis rather than a section 481(a) adjustment?  
   If "Yes," do not complete lines 25, 26, and 27 below.  

25 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income.  
   $  
   0  
   Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the same application, attach a list of the name, identification number, principal business activity code (see instructions), and the amount of the section 481(a) adjustment attributable to each applicant.  

Form 3115 (Rev. 12-2009)

Sample Form 3115
Form 3115, Application for Change in Accounting Method
Automatic Methods #184, #186, and #192

Company Name: Sample Company, LLC
Name of Applicant: N/A
Federal EIN: 12-3456789
Tax Year: 2014

Number 184: Deducting repairs and maintenance costs to capitalizing improvements and unit of property
Number 186: Change to deducting nonincidental materials and supplies to when used or consumed
Number 192: Change to capitalizing acquisition or production costs and, if depreciable, to depreciating such property under I.R.C. § 167 or I.R.C. § 168.

This Form 3115, Application for Change in Accounting Method, is filed to change to the automatic accounting methods #184, #186, and #192.
Method number 184 is filed to deduct repairs and maintenance costs, to capitalize amounts paid or incurred for improvements to tangible property, to adopt the routine maintenance safe harbor, and/or to change the method of identifying the unit of property.
Method number 186 is filed to adopt the nonincidental materials and supplies rules.
Method number 192 is filed to adopt the amounts paid to acquire or produce tangible property.

As required by Rev. Proc. 2014-16, the taxpayer is including the following method change(s), description(s), and regulation citation(s):

<table>
<thead>
<tr>
<th>Subject Matter or Issue</th>
<th>Citation to Treasury Regulation Section</th>
<th>Change Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repairs and maintenance</td>
<td>1.162-4(a)</td>
<td>184</td>
</tr>
<tr>
<td>Capital expenditures in general</td>
<td>1.263(a)-1(a)</td>
<td>184</td>
</tr>
<tr>
<td>Amounts paid to improve tangible property:</td>
<td></td>
<td>184</td>
</tr>
<tr>
<td>Definitions</td>
<td>1.263(a)-3(b)</td>
<td>184</td>
</tr>
<tr>
<td>Requirement to capitalize amounts paid</td>
<td>1.263(a)-3(d)</td>
<td>184</td>
</tr>
<tr>
<td>Unit of property (buildings, land improvements, tangible personal, and/or leased property)</td>
<td>1.263(a)-3(e) and 1.263(a)-3(f)</td>
<td>184</td>
</tr>
<tr>
<td>Special rules for determining improvement costs, certain costs incurred during an improvement in general</td>
<td>1.263(a)-3(g)(1)</td>
<td>184</td>
</tr>
<tr>
<td>Safe harbor for routine maintenance on property</td>
<td>1.263(a)-3(j)</td>
<td>184</td>
</tr>
<tr>
<td>Routine maintenance for buildings:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capitalization of betterments</td>
<td>1.263(a)-3(j)</td>
<td>184</td>
</tr>
<tr>
<td>Capitalization of restorations</td>
<td>1.263(a)-3(k)</td>
<td>184</td>
</tr>
<tr>
<td>Capitalization of amounts to adapt property to a new or different use</td>
<td>1.263(a)-3(l)</td>
<td>184</td>
</tr>
<tr>
<td>Capitalization of amounts to adapt property to a new or different use, buildings:</td>
<td></td>
<td>184</td>
</tr>
<tr>
<td>Treatment of capital expenditures</td>
<td>1.263(a)-3(o)</td>
<td>184</td>
</tr>
<tr>
<td>Recovery of capitalized amounts</td>
<td>1.263(a)-3(p)</td>
<td>184</td>
</tr>
<tr>
<td>Nonincidental materials and supplies</td>
<td>1.162-3(a)(1)</td>
<td>186</td>
</tr>
<tr>
<td>Materials and supplies definition</td>
<td>1.162-3(c)</td>
<td>186</td>
</tr>
<tr>
<td>Amounts paid to acquire or produce tangible property:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Requirement to capitalize</td>
<td>1.263(a)-2(d)</td>
<td>192</td>
</tr>
<tr>
<td>Defense or perfection of title to property</td>
<td>1.263(a)-2(e)</td>
<td>192</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>1.263(a)-2(f)</td>
<td>192</td>
</tr>
<tr>
<td>Treatment of capital expenditures</td>
<td>1.263(a)-2(g)</td>
<td>192</td>
</tr>
</tbody>
</table>
We have attached a completed and signed power of attorney, IRS Form 2848, covering this change in accounting method request.

In accordance with the requirements of Rev. Proc. 2015-1, § 9.04(3), please fax any requests for additional information to our tax representative Bob Doe, CPA, at: 111-111-1111.

PART II, QUESTION 9a: “Has the applicant, its predecessor, or related party requested or made (under either an automatic change procedure or a procedure requiring advance consent) a change in method of accounting within the past 5 years (including the year of change)?”

No. In any case, the eligibility requirements of section 5.01 of Rev. Proc. 2015-13, as described in Rev. Proc. 2014-16, do not apply to a taxpayer that makes these method changes for any tax year beginning before January 1, 2015. As such, the filing of this change in accounting method application is permitted whether the taxpayer has filed such method changes or not.

PART II, QUESTION 12: “If the applicant is either (i) not changing its overall method of accounting, or (ii) is changing its overall method of accounting and also changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following”:

a. The item(s) being changed: The taxpayer is changing methods of accounting for the following:
   1. Definition of, determining, and expensing nonincidental materials and supplies
   2. Determining and expensing of repairs and maintenance costs for its expenditures paid or incurred for tangible property to the rules outlined in Treas. Reg. § 1.162-4. Taxpayer’s prior accounting method followed superseded Treasury guidance that generally concluded that those amounts paid or incurred for tangible property required capitalization under I.R.C. § 263(a).
   3. Capital expenditures in general
   4. Determining the amount paid to acquire or produce tangible property
   5. Determining the amount to be capitalized as an improvement to tangible property
      a. The costing criteria of Treas. Reg. § 1.263(a)-3(j) for improvements to tangible property
      b. The betterment criteria of Treas. Reg. § 1.263(a)-3(k) for improvements to tangible property
      c. The restoration criteria of Treas. Reg. § 1.263(a)-3(l) for improvements to tangible property
   6. Safe harbor for routine maintenance under Treas. Reg. § 1.263(a)-3(i). The taxpayer has not been employing this method and seeks to add this method.
   7. Unit of property criteria for its building(s) and land improvements under Treas. Reg. § 1.263(a)-3(e)

b. The applicant’s present method for the item(s) being changed:
   1. Definition of, determining, and expensing nonincidental materials and supplies: The taxpayer currently expenses nonincidental material and supplies and proposes to change that accounting to deducting non-incidental materials and supplies when used or consumed.
   2. Determining and expensing of repairs and maintenance (see 5 below)
   3. Capital expenditures in general (see 5 below)
   4. Determining the amount paid to acquire or produce tangible property (see 5 below)
   5. Determining the amount to be capitalized as an improvement to tangible property. For these four above methods, the taxpayer currently accounts for amounts paid or incurred for tangible property as either items requiring capitalization under I.R.C. § 263(a) or as amounts for repairs and maintenance costs. The difference between the current and proposed method is that under the current method the taxpayer had been capitalizing items that now, under the guidance of Treas. Reg. § 1.162-4 and/or Treas. Reg. § 1.263(a)-3, will result in more items being deducted as I.R.C. § 162 ordinary and necessary business deductions as a repair and maintenance cost. For example, the taxpayer may have capitalized a $10,000 roof repair where clearly under Rev. Proc. 1.162-4 that expenditure should have been classified as a repair and maintenance cost. While the taxpayer has included the method changes described in items 3, 4, and 5 above, as a method change under Question 12a, it is not aware that its current accounting methods are...
contrary to Rev. Proc. 1.263(a)-2 or Rev. Proc. 1.263(a)-3. Therefore, the taxpayer does not have a section 481(a) adjustment related to those methods.

6. Safe harbor for routine maintenance. The taxpayer does not currently employ this method and proposes to utilize this method.

7. Unit of property. The taxpayer has not been employing any defined unit of property criteria.

c. The applicant’s proposed method for the item(s) being changed:

The taxpayer proposes to use the guidance in Treas. Reg. § 1.162-3 related to nonincidental materials and supplies, Treas. Reg. § 1.162-4, and other sections of the tangible property regulations to determine whether an expenditure should be written off as a repair and maintenance cost under Treas. Reg. § 1.263(a)-1, Treas. Reg. §§ 1.263(a)-2, and/or 1.263(a)-3(i), or should be capitalized. The taxpayer will employ the routine maintenance safe harbor of Treas. Reg. § 1.263(a)-3(i).

For these and other method changes, also see B earlier, other than “unit of property” under Treas. Reg. § 1.263(a)-3(e) as follows:

The taxpayer will account for any building as the building, its building structures, and its building systems as one unit of property. Additionally, the taxpayer will account for any land improvements consisting of its parking lots, landscaping, and outside lighting as one unit of property, separate from the building unit of property.

d. The applicant’s present overall method of accounting (cash, accrual, or hybrid):

The taxpayer currently employs the cash method of accounting.

Part II, Question 13: “Attach a detailed and complete description of the applicant’s trade(s) or business(es), and the principal business activity code for each. If the applicant has more than one trade or business as defined in Regulations section 1.446-1(d), describe: whether each trade or business is accounted for separately; the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; the overall method of accounting for each trade or business; and which trade or business is requesting to change its accounting method as part of this application or a separate application.”

The taxpayer has one trade or business, and it is a patent broker. Its business activity code is 541990.

Part IV, Question 25: There is no computation to summarize because there is a zero section 481(a) adjustment.

Additional information: The taxpayer agrees to the terms and conditions of Rev. Proc. 2015-13 and 2015-14 that are necessary or required to effect the method change(s) that is the subject matter of this application.
**Summary of Elections That Do Not Require Filing Form 3115**

**Figure 10.10** provides a summary of the tax elections under the final repair regulations.

### FIGURE 10.10 Summary of Elections under Final Repair Regulations

<table>
<thead>
<tr>
<th>Elections That Do Not Require Form 3115</th>
<th>Statement Required to Make Election?</th>
<th>What It Applies To</th>
<th>Revocation Allowed?</th>
<th>Treas. Reg. Sections</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capitalize certain materials and supplies (only rotatable, temporary, or standby emergency spare parts); an optional method is available</td>
<td>No. Election is made by treatment on a timely filed tax return (including extensions)</td>
<td>Rotatable, temporary, or standby emergency spare parts</td>
<td>Only by private letter ruling</td>
<td>1.162-3(d)</td>
</tr>
<tr>
<td>De minimis safe harbor ($5,000 with applicable financial statement, $500 without)</td>
<td>Yes. Attach election statement to timely filed tax return (including extensions) each year</td>
<td>All eligible materials and supplies and improvements</td>
<td>Irrevocable for the tax year elected</td>
<td>1.263(a)-1(f)</td>
</tr>
<tr>
<td>Capitalize employee compensation and overhead as amounts that facilitate an acquisition transaction</td>
<td>No. Election is made by treatment on a timely filed tax return (including extensions)</td>
<td>Each transaction, applies to either employee compensation or overhead, or both</td>
<td>Only by private letter ruling</td>
<td>1.263(a)-2(f)(iv)(B)</td>
</tr>
<tr>
<td>Safe harbor for small taxpayers with buildings (less than $10,000,000 in gross receipts, unadjusted building basis is less than $1,000,000)</td>
<td>Yes. Attach election statement to timely filed tax return (including extensions) each year</td>
<td>Applies only if total costs &lt; $10,000 or 2% of the unadjusted basis of building</td>
<td>Irrevocable for the tax year elected</td>
<td>1.263(a)-3(h)</td>
</tr>
<tr>
<td>Capitalize repair and maintenance costs (must be consistent with financial statements)</td>
<td>Yes. Attach election statement to timely filed tax return (including extensions) each year</td>
<td>All repair and maintenance costs capitalized for financial accounting purposes</td>
<td>Irrevocable for the tax year elected</td>
<td>1.263(a)-3(n)</td>
</tr>
<tr>
<td>Partial disposition election (note: late partial disposition election requires filing Form 3115)</td>
<td>No. Election is made by treatment on a timely filed tax return (including extensions)</td>
<td>Any MACRS property</td>
<td>Only by private letter ruling</td>
<td>1.168(i)-8(d)</td>
</tr>
</tbody>
</table>
Figure 10.11 provides a summary of the more important accounting method changes that may be made as a result of the final repair regulations. Figure 10.11 is adapted from section 3.02(8) of Rev. Proc. 2014-16 as updated by Rev. Proc. 2015-20.

**FIGURE 10.11 Summary of Accounting Method Changes under Final Repair Regulations**

<table>
<thead>
<tr>
<th>Change Number</th>
<th>General Topic</th>
<th>Purpose</th>
<th>Section 481(a) Adjustment Type</th>
<th>Treas. Reg. Sections</th>
<th>Comments/Concurrent Change on One Form 3115</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>Depreciation or amortization (impermissible)</td>
<td>Change from impermissible method to a permissible method for changes allowed under Treas. Reg. § 1.446-1(e)(2)(ii)(d), and for depreciable property owned at the beginning of the year of change</td>
<td>Cumulative adjustment</td>
<td>1.446-1(e)(2)(ii)(d)</td>
<td>No timing restrictions. Can be combined with other changes as noted in this summary.</td>
</tr>
<tr>
<td>21</td>
<td>Removal costs</td>
<td>Treatment of removal costs on disposal (entire or partial) of a depreciable asset</td>
<td>Cumulative adjustment</td>
<td>1.263(a)-3(g)(2)(i)</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Use a separate Form 3115 in accordance with the automatic change procedure in section 10.03(1) of Rev. Proc. 2015-14.</td>
</tr>
<tr>
<td>Change Number</td>
<td>General Topic</td>
<td>Purpose</td>
<td>Section 481(a) Adjustment Type</td>
<td>Treas. Reg. Sections</td>
<td>Comments/Concurrent Change on One Form 3115</td>
</tr>
<tr>
<td>---------------</td>
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<td>-------------------------------------------</td>
</tr>
<tr>
<td>180</td>
<td>Late GAA election</td>
<td>To make a late general asset account (GAA) election to recognize gain or loss on disposition of all assets, the last asset, or the remaining portion of the last asset; late election to recognize gain or loss upon disposition of assets in a qualifying disposition</td>
<td>Modified adjustment</td>
<td>1.168(i)-1, 1.168(i)-1(e)(3)(ii), 1.168(i)-1(e)(3)(iii)</td>
<td>Tax year beginning on or after 01/01/12 and beginning before 01/01/14. May require single Form 3115 if filed with other changes. Should file one Form 3115 for all assets that are subject to the GAA election.</td>
</tr>
<tr>
<td>184</td>
<td>Repair and maintenance costs, amounts for improvements to tangible property</td>
<td>Change to deduct amounts paid or incurred for repairs and maintenance</td>
<td>Cumulative adjustment</td>
<td>1.162-4, 1.263(a)-3</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>185</td>
<td>Regulated taxpayers</td>
<td>Change to a regulatory method of accounting</td>
<td>Modified adjustment</td>
<td>1.263(a)-3(m)</td>
<td>No timing restrictions because it is optional. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>186</td>
<td>Materials and supplies</td>
<td>Change to deduct nonincidental materials and supplies when used or consumed</td>
<td>Modified adjustment</td>
<td>1.162-3(a)(1), 1.162-3(c)(1)</td>
<td>No timing restrictions. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>187</td>
<td>Materials and supplies</td>
<td>Change to deduct incidental materials and supplies when paid or incurred</td>
<td>Modified adjustment</td>
<td>1.162-3(a)(2), 1.162-3(c)(1)</td>
<td>No timing restrictions. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>188</td>
<td>Rotable spare parts</td>
<td>Change to deduct nonincidental rotatable and temporary spare parts when disposed of</td>
<td>Modified adjustment</td>
<td>1.162-3(a)(3), 1.162-3(c)(2)</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>189</td>
<td>Rotable spare parts</td>
<td>Change to optional method</td>
<td>Cumulative adjustment</td>
<td>1.162-3(e)</td>
<td>No timing restrictions because it is optional. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>190</td>
<td>Dealers’ property sales</td>
<td>Change to deduct commissions and other transaction costs that facilitate the sale of property</td>
<td>Cumulative adjustment</td>
<td>1.263(a)-1(e)(2)</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>Change Number</td>
<td>General Topic</td>
<td>Purpose</td>
<td>Section 481(a) Adjustment Type</td>
<td>Treas. Reg. Sections</td>
<td>Comments/Concurrent Change on One Form 31157</td>
</tr>
<tr>
<td>---------------</td>
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<td>---------------------</td>
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</tr>
<tr>
<td>191</td>
<td>Nondealers’ property sales</td>
<td>Change to capitalize commissions and other costs that facilitate the sale of property</td>
<td>Cumulative adjustment</td>
<td>1.263(a)-1(e)(1)</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>192</td>
<td>Acquisition and production costs</td>
<td>Change to capitalize, and if depreciable, to depreciate under I.R.C. § 167 or 168</td>
<td>Cumulative adjustment</td>
<td>1.263(a)-2</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>192</td>
<td>Acquisition and production costs</td>
<td>Change to capitalize inherently facilitative amounts allocable to real or personal property even if property is not acquired</td>
<td>Modified adjustment</td>
<td>1.263(a)-2(f)(3)(ii)</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>193</td>
<td>Investigation costs for acquisition of real property</td>
<td>Change to deduct previously capitalized amounts incurred to investigate acquisition of real property</td>
<td>Modified adjustment</td>
<td>1.263(a)-2(f)(2)(iii)</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Can be combined with changes #184 through #193.</td>
</tr>
<tr>
<td>196</td>
<td>Late partial disposition election</td>
<td>Change to make a late election for the deduction of a partial disposition of an asset</td>
<td>Cumulative adjustment</td>
<td>1.168(i)-8(d)(2)(i), 1.168(i)-8(d)(2)(iv)(B)</td>
<td>Tax year beginning 01/01/2012 and before 01/01/2015 or 1st or 2nd tax year succeeding applicable tax year.</td>
</tr>
<tr>
<td>197</td>
<td>Revocation of GAA election</td>
<td>Change to revoke a GAA election</td>
<td>Cumulative adjustment</td>
<td>1.168(i)-1</td>
<td>Tax years beginning on or after 01/01/12 and before 01/01/2015. See Rev. Proc. 2015-14, § 6.34, for list of possible combinations.</td>
</tr>
<tr>
<td>198</td>
<td>Partial dispositions of assets to which IRS audit adjustment pertains (not in GAA)</td>
<td>Change to make partial dispositions of tangible depreciable assets to which the IRS’s adjustment pertains</td>
<td>Cumulative adjustment</td>
<td>1.168(i)-8(d)(2)(iii)</td>
<td>Applicable when audited by the IRS. Should file one Form 3115 for all assets that are being changed under this section.</td>
</tr>
<tr>
<td>199</td>
<td>Depreciation of leasehold improvements</td>
<td>Change to depreciate an interest in leasehold improvements</td>
<td>Cumulative adjustment</td>
<td>1.167(a)-4</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Can combine with certain UNICAP changes. See Rev. Proc. 2015-14, § 6.36.</td>
</tr>
<tr>
<td>Change Number</td>
<td>General Topic</td>
<td>Purpose</td>
<td>Section 481(a) Adjustment Type</td>
<td>Treas. Reg. Sections</td>
<td>Comments/Concurrent Change on One Form 3115</td>
</tr>
<tr>
<td>--------------</td>
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<td>----------------------------------------</td>
</tr>
<tr>
<td>200</td>
<td>Permissible to permissible</td>
<td>Change various permissible to permissible methods of accounting for depreciable MACRS property</td>
<td>Modified adjustment</td>
<td>1.168(i)-1(c), 1.168(i)-1(j)(2), 1.168(i)-1(j)(3), 1.168(i)-7, 1.168(i)-7(c), 1.168(i)-8(f)(2) or (3), 1.168(i)-8(g)</td>
<td>Tax year beginning 01/01/2012 and before 01/01/2015. See Rev. Proc. 2015-14, § 6.37, for list of possible combinations.</td>
</tr>
<tr>
<td>205</td>
<td>Disposition of building or structural component</td>
<td>Change to deduct partial disposition of a building or structural component</td>
<td>Cumulative adjustment</td>
<td>1.168(i)-8(d)(1)</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/1/2014. Can combine with Change #7 for the same asset in tax years before 01/01/2015. May require single Form 3115 if filed with other changes.</td>
</tr>
<tr>
<td>206</td>
<td>Disposition of tangible depreciable assets other than building or structural component</td>
<td>Change method of accounting for disposing of I.R.C. § 1245 property or depreciable land improvements to which a partial disposition rule applies</td>
<td>Cumulative adjustment</td>
<td>1.168(i)-8(d)(1), 1.263(a)-3(k)</td>
<td>No timing restrictions, may require single Form 3115 if filed with other changes. Can combine with change #7 for the same asset in tax years before 01/01/2015.</td>
</tr>
<tr>
<td>207</td>
<td>Dispositions of assets in GAA</td>
<td>Change from various impermissible to permissible methods involving disposition of tangible assets or portion of tangible assets in a GAA</td>
<td>Cumulative adjustment</td>
<td>1.168(i)-1(e)(2) (viii), 1.168(i)-1(j)(2), 1.168(i)-1(j)(3)</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. Can combine with change #7 for the same asset in tax years before 01/01/2015.</td>
</tr>
<tr>
<td>215</td>
<td>Depletion</td>
<td>Change method of accounting treat depletion amounts as an indirect cost that is only properly allocable to property that has been sold</td>
<td>Cumulative adjustment</td>
<td>1.263A-1(e)(3)(ii)(J)</td>
<td>No timing restrictions, taxpayers are required to comply for tax years beginning 01/01/2014. May require single Form 3115 if filed with other changes.</td>
</tr>
</tbody>
</table>
The following decision tree provides a bird’s-eye view of the new repair regulations.

**SIMPLIFIED DECISION TREE FOR APPLYING THE NEW REPAIR REGULATIONS**

* Rotable, temporary, and emergency spare parts are not included in this decision tree. See Treas. Reg. § 1.162-3 for the rules that apply to those parts.

**Start here.**

- **Erective safe harbors**
  Did the taxpayer elect and does the amount paid qualify for
  1. the de minimis safe harbor, or
  2. the small taxpayer safe harbor?
  - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
  - No: Book conformity safe harbor
    Did the taxpayer capitalize the amount paid under the book conformity safe harbor election?
    - No: Another capital activity
      Did the amount paid directly benefit or was it incurred by reason of another capital activity?
      - Yes: CAPITALIZE
      - No: Materials and supplies
        Was the amount paid for materials or supplies?
        - Yes: Were the materials or supplies used to improve property?
          - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
          - No: Routine maintenance safe harbor
            Does the amount paid qualify for the routine maintenance safe harbor?
            - Yes: CAPITALIZE
            - No: Restoration
              Does the amount paid do one or more of the following?
              1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
              2. Restore damage resulting from a casualty
              3. Return the unit of property to normal operating condition after falling into a state of disrepair
              - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
              - No: Restoration (continued)
                Does the amount paid do one or both of the following?
                1. Replace a major component or substantial structural part
                2. Rebuild the unit of property to a like-new condition after the end of its class life
                - Yes: Deduct when first used or consumed (subject to I.R.C. § 263A)
                - No: Betterment
                  Does the amount paid do one or more of the following?
                  1. Correct a preexisting defect
                  2. Materially add to or expand a unit of property
                  3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                  - Yes: CAPITALIZE
                  - No: Adaptation
                    Has the unit of property been adapted to a new or different use?
                    - Yes: CAPITALIZE
                    - No: Restoration
                      Does the amount paid do one or more of the following?
                      1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                      2. Restore damage resulting from a casualty
                      3. Return the unit of property to normal operating condition after falling into a state of disrepair
                      - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                      - No: Betterment
                        Does the amount paid do one or more of the following?
                        1. Correct a preexisting defect
                        2. Materially add to or expand a unit of property
                        3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                        - Yes: CAPITALIZE
                        - No: Adaptation
                          Has the unit of property been adapted to a new or different use?
                          - Yes: CAPITALIZE
                          - No: Restoration
                            Does the amount paid do one or more of the following?
                            1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                            2. Restore damage resulting from a casualty
                            3. Return the unit of property to normal operating condition after falling into a state of disrepair
                            - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                            - No: Betterment
                              Does the amount paid do one or more of the following?
                              1. Correct a preexisting defect
                              2. Materially add to or expand a unit of property
                              3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                              - Yes: CAPITALIZE
                              - No: Adaptation
                                Has the unit of property been adapted to a new or different use?
                                - Yes: CAPITALIZE
                                - No: Restoration
                                  Does the amount paid do one or more of the following?
                                  1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                                  2. Restore damage resulting from a casualty
                                  3. Return the unit of property to normal operating condition after falling into a state of disrepair
                                  - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                                  - No: Betterment
                                    Does the amount paid do one or more of the following?
                                    1. Correct a preexisting defect
                                    2. Materially add to or expand a unit of property
                                    3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                                    - Yes: CAPITALIZE
                                    - No: Adaptation
                                      Has the unit of property been adapted to a new or different use?
                                      - Yes: CAPITALIZE
                                      - No: Restoration
                                        Does the amount paid do one or more of the following?
                                        1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                                        2. Restore damage resulting from a casualty
                                        3. Return the unit of property to normal operating condition after falling into a state of disrepair
                                        - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                                        - No: Betterment
                                          Does the amount paid do one or more of the following?
                                          1. Correct a preexisting defect
                                          2. Materially add to or expand a unit of property
                                          3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                                          - Yes: CAPITALIZE
                                          - No: Adaptation
                                            Has the unit of property been adapted to a new or different use?
                                            - Yes: CAPITALIZE
                                            - No: Restoration
                                              Does the amount paid do one or more of the following?
                                              1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                                              2. Restore damage resulting from a casualty
                                              3. Return the unit of property to normal operating condition after falling into a state of disrepair
                                              - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                                              - No: Betterment
                                                Does the amount paid do one or more of the following?
                                                1. Correct a preexisting defect
                                                2. Materially add to or expand a unit of property
                                                3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                                                - Yes: CAPITALIZE
                                                - No: Adaptation
                                                  Has the unit of property been adapted to a new or different use?
                                                  - Yes: CAPITALIZE
                                                  - No: Restoration
                                                    Does the amount paid do one or more of the following?
                                                    1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                                                    2. Restore damage resulting from a casualty
                                                    3. Return the unit of property to normal operating condition after falling into a state of disrepair
                                                    - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                                                    - No: Betterment
                                                      Does the amount paid do one or more of the following?
                                                      1. Correct a preexisting defect
                                                      2. Materially add to or expand a unit of property
                                                      3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                                                      - Yes: CAPITALIZE
                                                      - No: Adaptation
                                                        Has the unit of property been adapted to a new or different use?
                                                        - Yes: CAPITALIZE
                                                        - No: Restoration
                                                          Does the amount paid do one or more of the following?
                                                          1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                                                          2. Restore damage resulting from a casualty
                                                          3. Return the unit of property to normal operating condition after falling into a state of disrepair
                                                          - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                                                          - No: Betterment
                                                            Does the amount paid do one or more of the following?
                                                            1. Correct a preexisting defect
                                                            2. Materially add to or expand a unit of property
                                                            3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                                                            - Yes: CAPITALIZE
                                                            - No: Adaptation
                                                              Has the unit of property been adapted to a new or different use?
                                                              - Yes: CAPITALIZE
                                                              - No: Restoration
                                                                Does the amount paid do one or more of the following?
                                                                1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                                                                2. Restore damage resulting from a casualty
                                                                3. Return the unit of property to normal operating condition after falling into a state of disrepair
                                                                - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                                                                - No: Betterment
                                                                  Does the amount paid do one or more of the following?
                                                                  1. Correct a preexisting defect
                                                                  2. Materially add to or expand a unit of property
                                                                  3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                                                                  - Yes: CAPITALIZE
                                                                  - No: Adaptation
                                                                    Has the unit of property been adapted to a new or different use?
                                                                    - Yes: CAPITALIZE
                                                                    - No: Restoration
                                                                      Does the amount paid do one or more of the following?
                                                                      1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                                                                      2. Restore damage resulting from a casualty
                                                                      3. Return the unit of property to normal operating condition after falling into a state of disrepair
                                                                      - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                                                                      - No: Betterment
                                                                        Does the amount paid do one or more of the following?
                                                                        1. Correct a preexisting defect
                                                                        2. Materially add to or expand a unit of property
                                                                        3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                                                                        - Yes: CAPITALIZE
                                                                        - No: Adaptation
                                                                          Has the unit of property been adapted to a new or different use?
                                                                          - Yes: CAPITALIZE
                                                                          - No: Restoration
                                                                            Does the amount paid do one or more of the following?
                                                                            1. Replace a component for which the taxpayer recognized gain or loss on the disposition or sale
                                                                            2. Restore damage resulting from a casualty
                                                                            3. Return the unit of property to normal operating condition after falling into a state of disrepair
                                                                            - Yes: Deduct in year the amount was paid or incurred (subject to I.R.C. § 263A)
                                                                            - No: Betterment
                                                                              Does the amount paid do one or more of the following?
                                                                              1. Correct a preexisting defect
                                                                              2. Materially add to or expand a unit of property
                                                                              3. Materially increase the quality, productivity, capacity, or efficiency of a unit of property
                                                                              - Yes: CAPITALIZE
                                                                              - No: Adaptation
                                                                                Has the unit of property been adapted to a new or different use?
                                                                                - Yes: CAPITALIZE
                                                                                - No: Restoration
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The purpose of this decision tree is to display the relationships among the provisions in the new repair regulations. Because it is an overview, it leaves out many of the details that are discussed earlier in this chapter.

Footnotes for Simplified Decision Tree for Repair Regulations


2. See pages 387–388 in this chapter for a discussion of the book conformity election [Treas. Reg. § 1.263(a)-3(n)].

3. Treas. Reg. § 1.263(a)-3(g)(1)(i) and (2)(i)

4. See pages 372–373 in this chapter for a discussion of materials and supplies [Treas. Reg. § 1.162-3].

5. See pages 353–356 in this chapter for a discussion of betterments to a unit of property [Treas. Reg. § 1.263(a)-3(j)]. See pages 366–371 in this chapter for a discussion of the term unit of property [Treas. Reg. § 1.263(a)-3(e)].

6. See pages 365–366 in this chapter for a discussion of adaption of a unit of property to a new or different use [Treas. Reg. § 1.263(a)-3(l)]. See pages 366–371 in this chapter for a discussion of the term unit of property [Treas. Reg. § 1.263(a)-3(e)].

7. See pages 356–365 in this chapter for a discussion of restorations to a unit of property [Treas. Reg. § 1.263(a)-3(k)]. See pages 366–371 in this chapter for a discussion of the term unit of property [Treas. Reg. § 1.263(a)-3(e)].

8. See pages 380–383 in this chapter for a discussion of the routine maintenance safe harbor [Treas. Reg. § 1.263(a)-3(i)].