

# The final tangible property regulations – Part III

## General improvement rules

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In September 2013, the Treasury Department and the Internal Revenue Service (IRS) (hereinafter called the government), released the much-anticipated final (and proposed) tangible property regulations (the final regulations). The majority of the regulations were issued in final form.<sup>1</sup> However, as expected, regulations surrounding dispositions of tangible property were issued in proposed form, but also as reliance guidance.

The government has not yet released updated transitional guidance (superseding [Rev. Procs. 2012-19](#) and [2012-20](#), which provide the automatic method change procedures for taxpayers to early adopt provisions of the temporary regulations). It is expected that such guidance will be issued in December 2013.

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<sup>1</sup> See [TD 9636](#).

This third article in a four-part series providing insight on the final regulations focuses on the clarifications and modifications made to the general improvement rules (for the first and second articles in this series, see [The final tangible property regulations – Part I](#) and [Part II](#)). While the improvement rules are substantially the same, the final regulations clarify and modify certain provisions, and provide additional examples intended to better guide taxpayers in applying the rules on a facts and circumstances basis. These clarifications, modifications and additions are discussed in depth below with respect to the betterment, restoration and adaptation standards. The fourth and final article in this series will discuss the new proposed regulations governing dispositions and general asset accounts (GAAs).

## Overview

The final regulations provide the framework for determining the deductibility versus capitalization of costs incurred for materials and supplies, repairs and maintenance and other tangible assets. Specifically, the final regulations provide rules in the following five general areas:

1. Materials and supplies
2. Capital expenditures in general (including the de minimis safe harbor)
3. Costs to acquire or produce tangible property
4. Costs to improve tangible property
5. Dispositions of Modified Accelerated Cost Recovery System (MACRS) property (including components thereof) and GAAs (in proposed form)

Throughout each of these areas, the final regulations retain many of the provisions of the temporary regulations, while also favorably clarifying, modifying and simplifying some of the provisions (e.g., a simplified de minimis safe harbor election). The final regulations also provide small business relief (i.e., a safe harbor election for improvements to eligible building property) and re-propose new rules (i.e., for dispositions).

As with the temporary regulations, the final regulations, under Reg. section 1.263(a)-3, generally require the capitalization of amounts paid or incurred for the improvement of a tangible unit of property (UOP).<sup>2</sup> An improvement will be deemed to occur if the amounts expended result in the betterment of a UOP, the restoration of a UOP or the adaptation of a UOP to a new or different use (the "improvement standards").<sup>3</sup> Following is a discussion of the final rules governing each of these improvement standards.

## Amounts paid for the betterment of a UOP

Pursuant to Reg. section 1.263(a)-3(j), an amount results in the betterment of a UOP if it:

1. Corrects a material condition or defect that existed prior to the taxpayer's acquisition of the UOP or arose during the production of the UOP, regardless of whether the taxpayer was aware of the condition or defect at the time of acquisition or production;
2. Is for a material addition to the UOP or a material increase in the capacity of the UOP; or
3. Is reasonably expected to materially increase the productivity, efficiency, strength, quality or output of the UOP.<sup>4</sup>

While generally in line with the temporary regulations, the final regulations do provide certain modifications intended to clarify application of the rules to particular situations and UOPs. Specifically, the final regulations provide that a material addition includes the addition of a "major component." As discussed in more detail in the restoration section below, a major component is generally "any component or group of components that performs a discrete and critical function in the operation of the [UOP]."<sup>5</sup> Thus, the final regulations clarify that a "material addition" includes not only large physical additions, but also the addition of a major component, regardless of the physical size of such component. The final regulations also

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2 As with the temporary regulations, the UOP determination continues to be the foundation for the improvement versus repair analysis. See [The final tangible property regulations – Part II](#) (the second article in this four-part series) for a discussion of how units of property are defined under the final regulations.

3 See [The final tangible property regulations – Part I](#) and [Part II](#) (the first and second articles in this four-part series) for a discussion of certain safe harbors that may apply to keep otherwise capitalizable improvement costs from being capitalized under the final regulations.

4 Reg. section 1.263(a)-3(j)(1)(i) – (iii).

5 Reg. section 1.263(a)-3(k)(6)(i)(A).

modify the temporary regulations with respect to the rule regarding a material increase in the productivity, efficiency, strength, quality or output of the UOP by providing that an amount is deemed to result in a betterment in this case only if it is "reasonably expected" to result in a material increase in one of these factors. By including these modifications and additions, the final regulations not only clarify that taxpayers should undertake both a qualitative and quantitative analysis in applying the betterment standards, but also provide an overall rule that may be applied more easily in the case of amounts expended for a project that will span more than one tax year, or where the outcome of expenditures is uncertain when the expenditures occur.

The final regulations further clarify that the application of each qualitative and quantitative factor depends on the nature of the UOP. To the extent a factor cannot be measured, taxpayers may treat such a factor as irrelevant in applying the betterment rules to an expenditure.<sup>6</sup> For instance, the regulations add an example in which a taxpayer pays amounts to remove a drop ceiling on the first floor of a building owned by the taxpayer and used in its trade or business.<sup>7</sup> The example provides that under the applicable facts, the taxpayer is not required to treat the amount paid as a betterment to the building because it was not for a material addition to or increase in the capacity of the building structure (the relevant building system or structure), and was not reasonably expected to materially increase the efficiency, strength or quality of the structure. Because the effect on the productivity and output of the building structure could not be measured in this context, the example states that these factors are not relevant in determining whether there is a betterment to the building.

The temporary regulations included a comparison rule to guide taxpayers in applying the betterment standards in certain situations, and the final regulations clarify that this rule only applies in the context of normal wear and tear or damage to a UOP, and only if such wear and tear or damage occurs during the taxpayer's use of the property. Specifically, under Reg. section 1.263(a)-3(j)(2)(iv), where an amount is expended to correct the effects of normal wear and tear that occurred during the taxpayer's use of the UOP, the taxpayer should compare the condition of the UOP immediately after the expenditure with the condition of the UOP immediately after the last time the taxpayer corrected the effects of normal wear and tear (or the condition of the property when placed in service if the taxpayer has not previously corrected the effects of normal wear and tear). Alternatively, where an amount is expended to correct damage to a UOP that occurred during the taxpayer's use of the UOP, Reg. section 1.263(a)-3(j)(2)(iv) provides that the taxpayer should compare the condition of the property immediately after the expenditure with the condition of the property immediately prior to the damage. Thus, the final regulations make it clear that the comparison rule is only applicable in certain situations (i.e., when amounts are expended to correct wear and tear or damage to a UOP occurring during the taxpayer's use of the property). This clarification should reduce ambiguity caused by the temporary regulations, which provided that the comparison rule would apply in the case of wear and tear or a "particular event," and contained no limiting language regarding when the wear and tear or particular event occurred.

Finally, the betterment standards continue to apply on a facts and circumstances basis. Although no bright-line tests are provided, the regulations do modify and add several examples to provide additional guidance to taxpayers in applying the betterment standards to amounts paid or incurred with respect to UOPs.

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6 See Reg. section 1.263(a)-3(j)(2)(i), which provides that "if an addition or an increase in a particular factor cannot be measured in the context of a specific type of property, this factor is not relevant in the determination of whether an amount has been paid for a betterment" to the UOP.

7 See Reg. section 1.263(a)-3(j)(3), example 18.

## SUMMARY OF CHANGES TO THE BETTERMENT STANDARDS UNDER THE GENERAL IMPROVEMENT RULES

Issue	Temporary regulations	Final regulations
<b>Amounts paid or incurred to improve a unit of property – betterments</b>		
Betterment standards	<ul style="list-style-type: none"> <li>· Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the UOP or arose during production of the UOP, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production</li> <li>· Results in a material addition (including a physical enlargement, expansion or extension) to the UOP</li> <li>· Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, quality or output of the UOP</li> </ul>	<ul style="list-style-type: none"> <li>· Generally the same as the temporary regulations, with the following modifications: <ul style="list-style-type: none"> <li>– Includes the addition of a major component</li> <li>– With respect to the third standard, taxpayer must reasonably expect the amount to result in a material increase in productivity, efficiency, strength, quality or output</li> </ul> </li> <li>· Clarify that qualitative and/or quantitative factors that cannot be measured in the context of a particular UOP are irrelevant to the analysis</li> </ul>
Comparison rule	<ul style="list-style-type: none"> <li>· Applies to amounts expended as a result of normal wear and tear and/or a particular event.</li> <li>· No limiting language regarding timing of wear and tear or damage</li> </ul>	<ul style="list-style-type: none"> <li>· Applies to amounts expended as a result of normal wear and tear and/or damage</li> <li>· Comparison rule only applicable where normal wear and tear or damage occurred during taxpayer's use of the UOP</li> </ul>
Application	<ul style="list-style-type: none"> <li>· Facts and circumstances (no bright-line tests)</li> </ul>	<ul style="list-style-type: none"> <li>· Same</li> </ul>
Effective date (in general)	<ul style="list-style-type: none"> <li>· May be applied to tax years beginning on or after Jan. 1, 2012 (and before Jan. 1, 2014)</li> </ul>	<ul style="list-style-type: none"> <li>· Must be applied to tax years beginning on or after Jan. 1, 2014</li> <li>· May be applied to tax years beginning on or after Jan. 1, 2012</li> </ul>

### Amounts paid for the restoration of a UOP

Pursuant to Reg. section 1.263(a)-3(k), an amount results in a restoration to a UOP if it:

- Is for the replacement of a component of a UOP for which the taxpayer has properly deducted a loss (other than a casualty loss under Reg. section 1.165-7);
- Is for the replacement of a component of a UOP 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 such component;
- Is for the restoration of damage to a UOP for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165 (the "casualty loss rule");
- Returns the UOP to its ordinarily efficient operating condition if the property has deteriorated to a state of nonfunctional disrepair;
- Results in the rebuilding of a UOP to a like-new condition after the end of its alternative depreciation system (ADS) class life; or
- Is for the replacement of a major component or substantial structural part of a UOP.<sup>8</sup>

<sup>8</sup> See Reg. section 1.263(a)-3(k)(1)(i) – (vi).

Although these rules are largely unchanged from the temporary regulations, the final regulations add several modifying and clarifying provisions intended not only to ease the impact of the rules, but also to reduce ambiguity in analyzing costs under the restoration standards.

First, the final regulations add a salvage value exception for taxpayers that pay or incur costs for the replacement of a component of a unit of pre-MACRS property where the taxpayer: (1) has properly deducted a loss (other than a casualty loss), or (2) has recognized a loss as a result of the sale or exchange of the component. In this case, if the UOP has been fully depreciated and the loss is attributable only to remaining salvage value, the taxpayer is not required to capitalize the replacement costs as a restoration under these standards.<sup>9</sup> However, taxpayers should note that they will need to analyze the costs in light of the remaining restoration, betterment and adaptation standards (discussed below) to determine whether the amount should be treated as a repair versus an improvement cost.

Additionally, in response to concerns regarding the harsh impact of the casualty loss rule in cases where a taxpayer has a low adjusted basis remaining on a valuable UOP, the final regulations provide a special rule that limits the amount that must be capitalized under the casualty loss rule to the adjusted basis of the UOP.<sup>10</sup> Amounts in excess of this limitation may be deducted only if they otherwise constitute repair costs under the rules of Reg. sections 1.162-4 and 1.263(a)-3 (thus, taxpayers must still analyze excess costs under the remaining restoration, betterment and adaptation standards).

The final regulations also clarify the definitions of "major component" and "substantial structural part" by providing that a major component is "a part or combination of parts that performs a discrete and critical function in the operation of the [UOP]," while a substantial structural part is "a part or combination of parts that comprises a large portion of the physical structure of the [UOP]."<sup>11</sup> By separately defining these terms, the final regulations clarify that a major component entails a qualitative analysis, while a substantial structural part entails a quantitative one.

Finally, the regulations provide that with respect to building property (i.e., one of the defined building systems or the building structure, as applicable), an amount will be treated as paid for the replacement of a major component if it is paid for the replacement of a major component or a significant portion of a major component.<sup>12</sup> Although this provision arguably applied under the temporary regulations,<sup>13</sup> those regulations failed to explicitly provide that a significant portion of a major component would be treated as a major component for purposes of the restoration rules. Thus, although the modification here is not taxpayer-favorable, it should assist taxpayers in properly applying this restoration standard under the final regulations.

As with the betterment standards, the restoration standards under the final regulations do not provide any bright-line tests for determining whether a restoration has occurred (i.e., whether a major component or a substantial structural part of a UOP has been replaced). Thus, the determination continues to be based on all the facts and circumstances; however, the regulations do include several examples to provide guidance to taxpayers in applying the restoration standards to amounts paid or incurred with respect to UOPs.

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9 See Reg. section 1.263(a)-3(k)(3).

10 See Reg. section 1.263(a)-3(k)(4).

11 Reg. section 1.263(a)-3(k)(6)(i)(A)-(B).

12 Reg. section 1.263(a)-3(k)(6)(ii).

13 See, e.g., Reg. section 1.263(a)-3T(i)(5), examples 13 and 24, where large portions of major components were treated as major components or substantial structural parts for which replacement costs were required to be capitalized as restorations.

## SUMMARY OF CHANGES TO THE RESTORATION STANDARDS UNDER THE GENERAL IMPROVEMENT RULES

Issue	Temporary regulations	Final regulations
<b>Amounts paid or incurred to improve a unit of property – restorations</b>		
Restoration standards	<ul style="list-style-type: none"> <li>· Replacement of component of UOP for which the taxpayer has properly deducted a loss (other than a casualty loss under Reg. section 1.165-7)</li> <li>· Replacement of component of UOP 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 such component</li> <li>· Restoration of damage to UOP for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165 (the “casualty loss rule”)</li> <li>· Returns the UOP to its ordinarily efficient operating condition if the property has deteriorated to a state of nonfunctional disrepair</li> <li>· Results in the rebuilding of UOP to a like-new condition after the end of its ADS class life</li> <li>· Is for the replacement of a major component or substantial structural part of UOP</li> </ul>	<ul style="list-style-type: none"> <li>· Same six standards as the temporary regulations</li> <li>· New salvage-value exception for loss recognized from sale/exchange or other dispositions (other than casualty loss) of pre-MACRS property</li> <li>· New limitation for restorations arising from the casualty loss rule</li> </ul>
Major component or substantial structural part	<ul style="list-style-type: none"> <li>· Includes a part or combination of parts that comprise a large portion of the physical structure of the UOP or that perform a discrete and critical function in the operation of the UOP</li> </ul>	<ul style="list-style-type: none"> <li>· Clarify that a major component includes a part or combination of parts that performs a discrete and critical function in the operation of the UOP (qualitative analysis)</li> <li>· Clarify that a substantial structural part is a part or combination of parts that comprises a large portion of the physical structure of the UOP (quantitative analysis)</li> <li>· Clarify that with respect to building property, a major component includes a significant portion of a major component of a building system or building structure, as applicable</li> </ul>
Application	<ul style="list-style-type: none"> <li>· Facts and circumstances (no bright-line tests)</li> </ul>	<ul style="list-style-type: none"> <li>· Same</li> </ul>
Effective date (in general)	<ul style="list-style-type: none"> <li>· May be applied to tax years beginning on or after Jan. 1, 2012 (and before Jan. 1, 2014)</li> </ul>	<ul style="list-style-type: none"> <li>· Must be applied to tax years beginning on or after Jan. 1, 2014</li> <li>· May be applied to tax years beginning on or after Jan. 1, 2012</li> </ul>

## Amounts paid for adaptation of a UOP

Pursuant to Reg. section 1.263(a)-3(l), an amount results in an adaptation to a UOP if it is paid to adapt a UOP to a new or different use that is inconsistent with the taxpayer's ordinary use of the property at the time originally placed in service by the taxpayer.<sup>14</sup> While this rule remains unchanged from the temporary regulations, the final regulations add three examples to better illustrate the application of the adaptation standard. These examples include the reconfiguration of a retail drug store to add a walk-in medical clinic (adaptation), the addition of a sushi bar to a grocery store that already contained a prepared food section with made-to-order options (not an adaptation) and the modification of a hotel emergency room to allow for both emergency care and outpatient surgery (not an adaptation).

As with the betterment and restoration standards, the improvement rules under the adaptation standard do not provide any bright-line rules for determining whether an amount results in the adaptation of a UOP to a new or different use. Thus, taxpayers must apply a facts and circumstances test in making such a determination while using the existing and additional examples to navigate areas where the existence of an adaptation is not readily apparent.

## SUMMARY OF CHANGES TO THE ADAPTATION STANDARD UNDER THE GENERAL IMPROVEMENT RULES

Issue	Temporary regulations	Final regulations
<b>Amounts paid or incurred to improve a unit of property – adaption</b>		
Adaptation standard	<ul style="list-style-type: none"><li>Adapts a UOP to a new or different use if the adaptation is not consistent with the taxpayer's ordinary use of the UOP at the time originally placed in service by the taxpayer</li></ul>	<ul style="list-style-type: none"><li>Same</li><li>Adds three examples to clarify the application of the standard</li></ul>
Application	<ul style="list-style-type: none"><li>Facts and circumstances (no bright-line tests)</li></ul>	<ul style="list-style-type: none"><li>Same</li></ul>
Effective date (in general)	<ul style="list-style-type: none"><li>May be applied to tax years beginning on or after Jan. 1, 2012 (and before Jan. 1, 2014)</li></ul>	<ul style="list-style-type: none"><li>Must be applied to tax years beginning on or after Jan. 1, 2014</li><li>May be applied to tax years beginning on or after Jan. 1, 2012</li></ul>

### Implications

The final regulations governing improvements to tangible property are generally taxpayer-favorable, as compared to the temporary regulations, and provide helpful clarifications and guidance. The final regulations not only provide provisions to soften the impact of the rules (e.g., through the casualty loss rule limitation and salvage value exceptions provided under the restoration rules), but also clarify areas of ambiguity under the temporary regulations (e.g., through separately defining major components and substantial structural parts of UOPs). Additionally, the final regulations modify and add several examples under each of the improvement standards in an effort to better guide taxpayers in properly applying the rules to their specific facts and circumstances. Finally, taxpayers should note that an amount may be required to be capitalized as an improvement cost under one standard, even if it falls outside the scope of another standard. Thus, costs to repair or improve any tangible property must be analyzed under each improvement standard before a taxpayer may conclude that the amount should be treated as a repair cost.

<sup>14</sup> Reg. section 1.263(a)-3(l)(1).

Taxpayers should also note that while the final regulations provide many safe harbors and rules through the use of annual elections (such as the de minimis safe harbor, the small taxpayer safe harbor and the election to capitalize repair and maintenance costs), the adoption and application of the provisions under the general improvement standards (betterments, restorations and adaptations) constitute methods of accounting. Therefore, while the transition guidance under the final regulations has yet to be released, it is likely that any change to adopt the general improvement rules will require the filing of one or more Forms 3115. Transition guidance providing automatic accounting method change procedures under the final regulations is expected to be released in December 2013, and such guidance will provide the procedures necessary to adopt the methods required by the general improvement rules under the final regulations. To the extent a safe harbor or rule is applied through an annual election, taxpayers should note that such an election must generally be made on a taxpayer's timely filed tax return for the year of the desired election. However, the final regulations generally provide for a special transition rule for taxpayers that desire to apply one or more elections to amounts paid or incurred in taxable years beginning on or after Jan. 1, 2012, and ending on or before Sept. 19, 2013. Under these rules, a taxpayer may have a limited time opportunity to amend their tax returns for such years to apply one or more of the elections under the final regulations.<sup>15</sup>

Because the final regulations provide many opportunities to reduce or increase current year taxable income, taxpayers should evaluate whether adopting one or more of the final regulation provisions for their taxable years beginning on or after Jan. 1, 2012, and ending on or before Dec. 31, 2013, is advantageous in light of their current year taxable income goals.

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<sup>15</sup> See, e.g., Reg. section 1.263(a)-2(f)(2)(iv)(B), providing eligible taxpayers with the ability to make a late election to capitalize employee compensation and/or overhead costs with respect to one or more acquisitions by filing an amended return within 180 days of the extended due date for the applicable tax year, regardless of whether the taxpayer extended such return. See also Reg. section 1.263(a)-3(r)(2)(ii) for a similar rule for late elections to apply the small taxpayer safe harbor and/or to capitalize repair and maintenance costs.

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