

Repair Regulations Overview

Kristy Maitre – Tax Specialist
 Center for Agricultural Law and Taxation
 October 26, 2015

IOWA STATE UNIVERSITY
CALT
 Center for Agricultural Law and Taxation



Flow Chart

Repair Regulations Client Checklist

- Late Partial Disposition Method Change**

Review Depreciation Schedule: Are there capitalized improvements?

Yes →

While a "qualified small taxpayer" is not required to file Form 3115, it is highly recommended to do so to remove partial disposition amounts on existing assets (2014 is the last year to do this) (Excludes item placed in service in closed years)

No

No Form 3115 Required
- Buildings**

Use safe harbor election on buildings (building-by-building) with current year capital improvements of \$10,000 or less and unadjusted basis of \$1,000,000 or less. (No Form 3115 Required Annual Election.)
- Review Current Year Asset Addition**

Any unnecessary capitalization?
- Review Current Year Repair Deduction**

Any items deducted as repairs need capitalization? (i.e., it's a betterment, restoration, or adaptation.)

Overview

- § 263(a) Requires capitalization for amounts:
 - Paid for new buildings, permanent improvements, or betterments made to increase the value of any property and
 - Paid in restoring property or in making good the exhaustion for which an allowance has been made
- § 162 Permits a deduction for amounts that are paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized
- Regulations purpose is to clarify the distinction between these standards

TD 9564
<ul style="list-style-type: none">• Issued in 2011• Decade in the making• Temporary and proposed regulations• Intent was to codify law based on court cases and previous rulings• All encompassing• Complex

Changes were Significant
<ul style="list-style-type: none">• Introduced the term: Unit of Property• Set a Capitalization standard• Added several safe harbors and simplifying procedures

What Did this Mean as It Relates to a Betterment, Restoration or Adaptation?
<ul style="list-style-type: none">• The improvement standard requires the taxpayer to:• Analyze the building• The building systems• To determine whether capitalization is required or they can expenses under §162

When is a Cost an Improvement?

- If it results in:
 - Betterment
 - Adaptation
 - Restoration
 - B A R = Improvement = Depreciate

What is a Unit of Property?

- Building and the structural components
- Building systems
 - Must apply improvement standards separately to each building structure and to each building system
- Roof – included in the meaning of building structure under Reg. §1.48-1(e)(1)
- Condominium - the individual unit and the structural components that are part of the condominium unit
- Cooperative - the portion of the building in which the taxpayer has possessory rights and the structural components that are part of the portion of the building subject to the taxpayer's possessory rights
- For real and personal property other than buildings, the regulations generally define a UOP as all components that are functionally interdependent, unless the taxpayer used a different depreciation method or recovery period for a component at the time it was placed in service

Separate Categories

- The regulations provide for the separate categories of a building creating multiple units of property
- Prior law treated the building inclusive of all the building systems as a single UOP

Other Separate Categories
<ul style="list-style-type: none"> • Plant Property • Network Assets • Leased property <u>other than leased buildings</u> <ul style="list-style-type: none"> – The amount paid for an improvement = an amount to acquire or produce the UOP – Improvements - generally are not a UOP separate from the UOP improved

Unit of Property
<ul style="list-style-type: none"> • Once the unit-of-property is determined, the new improvement standards from the final regulations can be applied

Further Defining a Unit of Property
<ul style="list-style-type: none"> • All the components of property that are functionally interdependent <ul style="list-style-type: none"> – Functional interdependence occurs if a component cannot be placed in service without another component • Special rules apply for determining the unit of property for buildings, plant property, and network assets • Special rules for determining the units of property for condominiums, cooperatives, and leased property, and for the treatment of improvements (including leasehold improvements) • The regulations generally defined a <u>building as a unit of property</u>, but required the application of the improvement standards to the building structure and the building systems

Unit of Property
<ul style="list-style-type: none">• The UOP serves as the measure of a piece of property• Guidance concerns how a UOP may be:<ul style="list-style-type: none">– Acquired– Placed in service– Repaired, or– Improved – application of the improvement standards• UOP rules apply only for:<ul style="list-style-type: none">– Capital expenditures,– Materials and supplies, and– Amounts paid to acquire, produce, or improve tangible property

Unit of Property
<ul style="list-style-type: none">• The unit-of-property must be identified before determining whether an expenditure can be deducted or must be capitalized• Generally, an expenditure must be capitalized if it improves a unit-of-property• An expenditure improves a unit-of-property if the amount paid results in a betterment, restoration, or an adaptation to a new or different use (the "improvement standards")

Exception to “functionally interdependent” Standard
<ul style="list-style-type: none">• In certain situations, a component may be treated as a separate UOP at the time it is placed in service• A client may properly treat the component as a different class of property from the larger UOP for MACRS depreciation purposes• A client may also properly depreciate the component using a different depreciation method from the larger UOP• Finally, a client may change the treatment of a component in any later year to its proper MACRS class or depreciation method

<h3>Exception to “functionally interdependent” Standard</h3>
<ul style="list-style-type: none"> • The reclassified portion of the UOP is treated as a separate UOP for capitalization purposes • For example, a client may classify the tires of a tractor as a separate asset for depreciation purposes • Thus a client who makes an improvement to the differently-classed tires would only need to capitalize the improvement costs to the tires, not the UOP of the truck

<h3>Requirement to Capitalize Amounts Paid for Improvements</h3>
<ul style="list-style-type: none"> • A client generally must capitalize the amounts paid to improve a unit of property, but <ul style="list-style-type: none"> – Review § 263A for the requirement to capitalize the direct and allocable indirect costs of property produced by the client and property acquired for resale – Review § 1016 for adding capitalized amounts to the basis of the unit of property – Review § 168 for the treatment of additions or improvements for depreciation purposes • For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer— <ul style="list-style-type: none"> – (1) Are for a betterment to the unit of property – (2) Restore the unit of property; or – (3) Adapt the unit of property to a new or different use

<h3>Radio – Unit of Property</h3>
<ul style="list-style-type: none"> • A radio will consist of various components, such as an antenna, transmitter, cables, and speakers, all of these components must work in order for the radio to function properly • The radio is a single UOP because it consists of components that are functionally interdependent • This treatment will have two effects on a UOP <ul style="list-style-type: none"> – First, an improvement made to a component of a UOP will be considered an improvement made to the UOP as a <u>whole</u> – Second, a taxpayer must then <u>capitalize</u> the costs of acquiring, producing, or improving the UOP • For example, if the client upgrades only the speakers of the radio, that upgrade will be treated as improving the entire radio • The costs of upgrading the speakers must be capitalized • Notice the term “upgrading” if the speakers were just replaced with same speakers, no capitalization would be required

Repair Regulations Betterments

Kristy Maitre – Tax Specialist
Center for Agricultural Law and Taxation
October 26, 2015



What is a Betterment?

- The final regulations provided that an amount paid results in a betterment, and accordingly, an improvement, if it:
- (1) Ameliorates a material condition or defect that existed prior to the acquisition of the property or arose during the production of the property;
- (2) Results in a material addition to the unit of property (including a physical enlargement, expansion, or extension); or
- (3) Results in a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output
- As applied to buildings, an amount results in a betterment to the building if it results in a betterment to the building structure or any of the building systems

What is a Betterment?

- The final regulations reorganize and clarify the types of activities that constitute betterments to property
- Also, the final regulations no longer phrase the betterment test in terms of amounts that result in a betterment
- The final regulations provide that a client must capitalize amounts that are reasonably expected to:
 - Materially increase the productivity
 - Efficiency
 - Strength
 - Quality
 - Output of a unit of property or
 - A material addition to a unit of property

Improvement of Material Condition or Defect

- An act or instance of improving or making better
- The state of being improved or made better:
- The improvement of working conditions
- An improvement

Material Addition or Increase in Productivity, Efficiency, Strength, Quality, or Output

- No bright line test
- Whether any single factor applies to a particular unit of property depends on the nature of the property
 - Example: Work performed on an office building or retail building may be a physical enlargement or increase the capacity, efficiency, strength, or quality of a building
 - How would that be measured?
- Thus, the productivity and output factors would not generally apply to buildings

Material Addition or Increase in Productivity, Efficiency, Strength, Quality, or Output

- It is appropriate to evaluate items of manufacturing equipment in terms of output or productivity as well as size, capacity, efficiency, strength, and quality
- The final regulations clarify that the applicability of the information or data available concerning the asset depends on the nature of the unit of property, and
- If the information or data cannot be measured on a specific type of property, then the factor is not relevant in determining whether there has been a betterment to the property

Appropriate Comparison
<ul style="list-style-type: none">• When an expenditure is necessitated by a particular event, the determination of whether an expenditure is for the betterment of a unit of property is made by comparing :<ul style="list-style-type: none">– The condition of the property immediately after the expenditure– With the condition of the property immediately prior to the event necessitating the expenditure– Must focuses on events affecting the condition of the property and not on business decisions made by taxpayers• In addition, the final regulations confirm that the rule does not apply to wear, tear, or damage that occurs prior to the taxpayer’s acquisition or use of the property<ul style="list-style-type: none">– In these situations, the improvement of a material condition or defect rule may apply

Application of the Betterment Rule to Buildings
<ul style="list-style-type: none">• An amount is paid to improve a building if it is paid for a betterment to a property that is a:<ul style="list-style-type: none">– Building– Condominium– Cooperative), or– Leased building or leased portion of building• For example, an amount is paid to improve a building if it is paid for an increase in the efficiency of the building structure or any one of its building systems (for example, the HVAC system)

Other Examples of Betterments
<ul style="list-style-type: none">• Tom acquires a tractor with 250 HP• He pays an additional \$10,000 to Turbo charge the engine = increasing the horsepower to 300 = Betterment• Eric overhauls a diesel engine in this tractors simplify maintaining and keeping it on operating condition = Repair

Unavailability of Replacement Parts

- If a taxpayer replaces a part of a unit of property that cannot reasonably be replaced with the same type of part the replacement of the part with an improved, but comparable, part does not, by itself, result in a betterment to the unit of property

Normal Wear and Tear

- If the expenditure is made to correct the effects of normal wear and tear to the unit of property
- The condition of the property immediately prior to the circumstances requiring the expenditure is:
 - The condition of the property after the last time the taxpayer corrected the effects of normal wear and tear or
 - If the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer

Damage to Property

- If the expenditure is made to correct damage to a unit of property that occurred during the taxpayer's use of the unit of property
- The condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to damage

Betterments
<ul style="list-style-type: none">• An amount is paid to improve a building unit of property if the amount is paid for a betterment to the <u>building structure</u> or any <u>building system</u>

Definitions
<ul style="list-style-type: none">• Unit of Property• Functional Interdependent• Routine Maintenance

Exemptions
<ul style="list-style-type: none">• Though the “functionally interdependent” applies to both real and personal property, the regulations carve out exemptions for many categories of property• They include:<ul style="list-style-type: none">– Buildings, including condominiums, cooperatives, and leased buildings;– Plant property;– Network assets;– Leased property;– Improvements to property;– Property and property components with different MACRS classes or depreciation methods; and– Property aggregated into asset

<p style="text-align: center;">Buildings</p>
<ul style="list-style-type: none">• The “functionally interdependent” standard <u>does not apply to buildings and building systems</u>• Generally, the regulations define a building’s UOP as the <u>building itself and its structural components</u>• Structural components of a building include walls, partitions, floors, ceilings, and permanent coverings• The regulations also create a separate class of structural components – building systems

<p style="text-align: center;">Nine Separate Building Systems</p>
<ul style="list-style-type: none">• Heating, ventilation, and air conditioning (HVAC) systems;• Plumbing systems;• Electrical systems;• All escalators;• All elevators;• Fire-protection and alarm systems;• Security systems;• Gas distribution systems; and• Other systems specifically designated in the Federal Register or Internal Revenue Bulletins

<p style="text-align: center;">Application of the Betterment Rule to Buildings</p>
<ul style="list-style-type: none">• An amount paid to improve a building is paid for a betterment to a property that is a:<ul style="list-style-type: none">– Building– Condominium– Cooperative), or– Leased building or leased portion of building• For example, an amount is paid to improve a building if it is for an increase in the efficiency of the building structure or any one of its building systems (HVAC system)

<h3>Examples</h3>
<ul style="list-style-type: none"> The following examples illustrate the application of the Betterment rules and do not address whether capitalization is required under <u>another</u> provision of the Internal Revenue Code

<p>Example A Improvement of Pre-existing Material Condition or Defect</p>
<ul style="list-style-type: none"> In 2015, Adam purchases a store located on a parcel of land that contains underground gasoline storage tanks left by prior occupants The parcel of land is the unit of property The tanks had leaked prior to the purchase, causing soil contamination Adam was unaware of the contamination when the store was purchased In 2016, Adam discovers the contamination and incurs costs to remediate the soil The remediation costs are for a betterment to the land because Adam incurred the costs <u>to improve a material condition or defect that existed prior to his acquisition of the land</u> The remediation cost would be capitalized

<p>Example B Not an Improvement of a Pre-existing Condition or Defect</p>
<ul style="list-style-type: none"> Bruce owns an office building that was constructed with insulation that contained asbestos Several years after Bruce places the building into service, he determines that certain areas of asbestos insulation have begun to deteriorate and could eventually pose a health risk to employees Bruce pays to remove the asbestos-containing insulation from the building structure and replace it with new insulation that is safer to employees, but no more <u>efficient or effective</u> than the asbestos insulation

Example B continued
Not an Improvement of a Pre-existing Condition or Defect

- Although the asbestos is determined to be unsafe under certain circumstances, the presence of asbestos insulation in a building, by itself, is not a preexisting material condition or defect of the building structure
- In addition, the removal and replacement of the asbestos is not for a material addition to the building structure or a material increase in the capacity of the building structure as compared to the condition of the property prior to the deterioration of the insulation
- Similarly, the removal and replacement of asbestos is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure as compared to the condition of the property prior to the deterioration of the insulation
- Therefore, the amount paid to remove and replace the asbestos insulation is not for a betterment to the building structure or an improvement to the building
- The cost can be expensed

Example C
Not an Improvement of Pre-existing Material Condition or Defect

- In January 2015, Clyde purchased a used machine for use in his manufacturing operations
- The machine is a unit of property and has a class life of 10 years
- Clyde placed the machine in service in January 2015 and at that time expected to perform manufacturer recommended scheduled maintenance on the machine every three years
- The scheduled maintenance includes:
 - Cleaning and oiling the machine
 - Inspecting parts for defects, and
 - Replacing minor items, such as springs, bearings, and seals, with comparable and commercially available replacement parts

Example C
Not an Improvement of Pre-existing Material Condition or Defect

- The scheduled maintenance does not include any material additions or materially increase the capacity, productivity, efficiency, strength, quality, or output of the machine
- At the time Clyde purchased the machine, it was approaching the end of a three-year scheduled maintenance period
- In February 2015, he performs the manufacturer recommended scheduled maintenance to keep the machine in its ordinarily efficient operating condition

Example C
Not an Improvement of Pre-existing Material Condition or Defect

- The amount that Clyde pays does not qualify under the routine maintenance safe harbor, because the cost primarily results from the prior owner's use of the property and not the taxpayer's use
- The amount that Clyde pays for the scheduled maintenance results from the prior owner's use of the property and improves conditions or defects that existed prior to Clyde's ownership of the machine
- Nevertheless, considering the purpose and minor nature of the work performed, this amount does not improve a material condition or defect in the machine and is not for a material addition to or increase in capacity of the machine
- It is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the machine
- Therefore, Clyde is not required to capitalize the amount paid for the scheduled maintenance as a betterment to the unit of property

Example D
Not an Improvement of Pre-existing Material Condition or Defect

- Danny purchases a used Zamboni machine for use in the operation of his ice skating rink
- He is required (local regulations) to routinely monitor the air quality in the ice skating rink
- One week after he places the machine into service, during a routine air quality check, he discovers that the operation of the machine is adversely affecting the air quality in the skating rink
- He pays an amount to inspect and retune the machine, which includes replacing minor components of the engine that had worn out prior to the acquisition of the machine
- The Zamboni, including the engine, is the unit of property
- As in the previous example, the routine maintenance safe harbor does not apply to the amounts paid, because the activities performed do not relate solely to the taxpayer's use of the machine

Example D continued
Not an Improvement of Pre-existing Material Condition or Defect

- The amount to inspect, retune, and replace minor components of the Zamboni machine improves a condition or defect that existed prior to the acquisition of the equipment
- Considering the purpose and minor nature of the work performed, this amount does not improve a material condition or defect in the machine, no material addition to the machine or a material increase in the capacity of the machine has been made
- In addition, the activities are not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the machine
- Danny is not required to capitalize the amount paid to inspect, retune, and replace minor components of the machine as a betterment

Major Component and Substantial Structural Part of Buildings

- Any amount that is for the replacement of a major component or substantial structural part includes: The replacement part or combination of parts that:
 - (1) Comprises a major component or a significant portion of a major component of the building structure or any building system, or
 - (2) Comprises a large portion of the physical structure of the building structure or any building system

**Example E
Improvement of a Material Condition or Defect**

- Edward, acquires a building for use in his business of providing assisted living services
- Before and after the purchase, the building functions as an assisted living facility
- At the time of the purchase, Edward is aware that the building is in a condition that is below the standards that are required for facilities used in this type of business
- Immediately after the acquisition and during the following two years, while Edward continues to use the building as an assisted living facility
- He pays amounts for extensive repairs and maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which Edward's other facilities are known

**Example E: continued
Improvement of a Material Condition or Defect**

- The work on the building includes repairing damaged to:
 - Drywall
 - Repainting
 - Re-wallpapering
 - Replacing windows
 - Repairing and replacing doors,
 - Replacing and re-grouting tile
 - Repairing millwork, and r
 - Repairing and replacing roofing materials
 - The work also involves the replacement of § 1245 property, including window treatments, furniture, and cabinets
 - The work that Edward performs affects only the building structure and does not affect any of the building systems
 - Each § 1245 property is a separate unit of property

Example E: continued
Improvement of a Material Condition or Defect

- An amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system
- When considering the purpose of the expenditure and the effect of the expenditures on the building structure:
 - The cost for repairs and maintenance to the building structure comprise a betterment to the building structure because the amounts improve material conditions that existed prior to the acquisition of the building
- Edward must treat the amounts paid for the betterment to the building structure as an improvement to the building and must capitalize the amounts
- He is also required to capitalize the amounts paid to acquire and install each § 1245 property, including each window treatment, each item of furniture, and each cabinet

Example F
Not a Betterment: Building Refresh

- Frank owns a nationwide chain of retail stores that sell a wide variety of items
- To maintain the appearance and functionality of its store buildings after several years of wear, Frank periodically pays amounts to refresh the look and layout of its stores
- The work that Frank performs during a refresh consists of cosmetic and layout changes to the store’s interiors and general repairs and maintenance to the store building to modernize the store buildings and reorganize the merchandise displays

Example F
Not a Betterment: Building Refresh

- The work to each store consists of :
 - Replacing and reconfiguring display tables and racks to provide better exposure of the merchandise = §1245 property
 - Making corresponding lighting relocations and flooring repairs
 - Moving one wall to accommodate the reconfiguration of tables and racks
 - Patching holes in walls
 - Repainting the interior structure with a new color scheme to coordinate with new signage
 - Replacing damaged ceiling tiles
 - Cleaning and repairing wood flooring throughout the store building, and
 - Power washing building exteriors

Example F: continued
Not a Betterment: Building Refresh

- Frank refreshes 50 stores during the taxable year
- Each § 1245 property within each store is a separate unit of property
- Finally, assume that the work does not improve any material conditions or defects that existed when he acquired the store buildings or result in any material additions to the store buildings

Example F : continued
Not a Betterment: Building Refresh

- Consider the facts and circumstances:
 - The purpose of the expenditure
 - The physical nature of the work performed
 - The effect of the expenditure on the buildings' structure and systems
 - The amounts paid for the refresh of each building are not:
 - Any material additions to
 - Material increases in the capacity of the buildings' structure or systems
 - When compared with the condition of the structure or systems after the previous refresh

Example F : continued
Not a Betterment: Building Refresh

- The amounts paid are not reasonably expected to materially increase the:
 - Productivity
 - Efficiency
 - Strength,
 - Quality, or
 - Output of any building structure or system when compared to the condition of the structures or systems after the previous refresh
- The work performed keeps Frank's store buildings' structures and buildings' systems in their ordinarily efficient operating condition
- Frank is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments
- However, Frank is required to capitalize the amounts paid to acquire and install each § 1245 property

Example G
Building refresh: limited improvement

- Assume the same facts in the previous example except, in the course of the refresh to one of its store buildings, Frank also pays amounts to:
 - Increase the building’s storage space
 - Add a second loading dock
 - Add a second overhead door
 - An upgrade to the electrical system of the building, including the addition of a second service box with increased amperage and
 - New wiring from the service box to provide lighting and power throughout the new space

Example G : continued
Building refresh: limited improvement

- The work is performed at the same time as the refresh, but the construction of the additions does not affect, and is not otherwise related to, the refresh of the retail space
- Betterment: an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system
- The amounts Frank paid to:
 - Add the storage space
 - Loading dock
 - Overhead door, and
 - Expand the electrical system
- All are betterments as they are material additions to, and a material increase in capacity of, the structure and the electrical system of Frank’s store

Example G: continued
Betterment

- Frank must treat the amounts paid for these betterments as improvements to the building unit of property and capitalize
- Frank is not required to treat the amounts paid for the refresh of its store building as capital improvements because:
 - These costs do not directly benefit and
 - Are not incurred by reason of the additions to the building structure and electrical system
- But, he is required to capitalize the amounts paid to acquire and install each § 1245 property

Example H
Betterment: Building Remodel

- George owns a large chain of retail stores
- He determines that due to changes in the retail market, it can no longer compete in its current store class and decides to upgrade the stores to offer higher end products to a different type of customer
- To offer these products and attract different types of customers, he must substantially remodel the stores
- George pays amounts to remodel its stores by performing work on the buildings' structures and systems

Example H : continued
Betterment: Building Remodel

- The work includes :
 - Replacing large parts of the exterior walls with windows
 - Replacing the escalators with a monumental staircase
 - Adding a new glass enclosed elevator
 - Rebuilding the interior and exterior facades
 - Replacing vinyl floors with ceramic flooring
 - Replacing ceiling tiles with acoustical tiles, and
 - Removing and rebuilding walls to move changing rooms and create specialty departments
- In addition, he upgrades to increase the capacity of the buildings' electrical system to accommodate the structural changes and
- The addition of new § 1245 property, such as new information kiosks and point of sale systems are purchased

Example H : continued
Betterment: Building Remodel

- The electrical system upgrade also involves the installation of new more efficient and mood enhancing lighting fixtures
- In addition, the work includes:
 - Remodeling all bathrooms by replacing contractor-grade plumbing fixtures with designer-grade fixtures that conserve water and energy
- Finally, George also pays amounts to :
 - Clean debris resulting from construction during the remodel
 - Patch holes in walls that were made to upgrade the electrical system
 - Repaint existing walls with a new color scheme to match the new interior construction, and
 - Power wash building exteriors to enhance the new exterior facade

Example H : continued
Betterment: Building Remodel

- The amount paid to improve a building unit of property if paid for a betterment to the building structure or any building system
- Consider the facts and circumstances, including
 - The purpose of the expenditure
 - The physical nature of the work performed, and
 - The effect of the work on the buildings' structures and buildings' systems
- The amounts that George pays for the remodeling of its stores result in betterments to the buildings' structures and several of its systems

Example H : continued
Betterment: Building Remodel

- Specifically, the amounts paid to:
 - Replace large parts of the exterior walls with windows
 - Replace the escalators with a monumental staircase
 - Add a new elevator
 - Rebuild the interior and exterior facades
 - Replace vinyl floors with ceramic flooring
 - Replace the ceiling tiles with acoustical tiles, and
 - To remove and rebuild walls
- All are material additions:
- That is the addition of major components, to the building structure and are reasonably expected to increase the quality of the building structure

Example H : continued
Betterment: Building Remodel

- As to the upgrade of the electrical system, they were to materially increase the capacity of the electrical system and are reasonably expected to increase the quality of this system
- In addition, the amounts paid to remodel the bathrooms with higher grade and more resource-efficient materials are reasonably expected to increase the efficiency and quality of the plumbing system

Example H : continued
Betterment: Building Remodel

- Finally, the amounts paid to:
 - Clean debris
 - Patch and repaint existing walls with a new color scheme, and
 - Power wash building exteriors
- While not betterments by themselves, directly benefitted and were incurred by reason of the improvements to George’s store buildings’ structures and electrical systems
- Therefore, George must treat the amounts paid for betterments to the store buildings’ structures and systems, including the costs of cleaning, patching, repairing, and power washing the building, as improvements to his buildings and must capitalize
- In addition, George, is required to capitalize the amounts paid to acquire and install each § 1245 property

Example I
Not Betterment: Relocation and Reinstallation of Personal Property

- In 2015, Henry purchases new cash registers for use in its retail store located in leased space in a shopping mall
- Each cash register is a unit of property
- In 2015, Henry capitalizes the costs of acquiring and installing the new cash registers
- In 2017, his lease expires, and he decides to relocate its retail store to a different building

Example I
Not Betterment: Relocation and Reinstallation of Personal Property

- In addition to various other costs, he pays \$5,000 to move the cash registers and \$1,000 to reinstall them in the new store
- The cash registers are used for the same purpose and in the same manner that they were used in the former location
- The amounts that Henry pays to move and reinstall the cash registers into its new store does not result in a betterment to the cash registers, the costs can be deducted as an expense

Example J
Betterment: Relocation and Reinstallation of Equipment

- Jessica operates a manufacturing facility in Building A, which contains various machines that she uses in her manufacturing business
- She decides to expand part of its operations by relocating a machine to Building B and reconfigure the machine with additional components
- The machine is a single unit of property
- Jessica pays amounts to:
 - Disassemble the machine
 - Move the machine to the new location, and
 - Reinstall the machine in a new configuration with additional components

Example J : continued
Betterment: Relocation and Reinstallation of Equipment

- The reinstallation, including the reconfiguration and the addition of components, was for an increase in capacity of the machine – a betterment
- Jessica must capitalize:
 - Costs of reinstalling the machine as an improvement to the machine
 - Costs of disassembling and moving the machine to Building B
- The costs directly benefit and are incurred by reason of the improvement to the machine

Example K
Material Increase in Capacity: Building

- Nathan owns a factory building with a storage area on the second floor
- He reinforced the columns and girders supporting the second floor to permit storage of supplies with a gross weight 50 percent greater than the previous load-carrying capacity of the storage area
- *An amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system*

Example K
Material Increase in Capacity: Building

- The columns and girders are part of the building structure
- Nathan must treat the amount paid to reinforce the columns and girders as a betterment because it materially increases the load-carrying capacity and the strength of the building structure
- Nathan must capitalize this amount as an improvement to the building

Example L
Not a Material Increase in Capacity: Building

- Patti owns a building used in its trade or business
- The first floor has a drop-ceiling
- Patti pays an amount to remove the drop-ceiling and repaint the original ceiling
- *The amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system*
- The ceiling is part of the building structure

Example L
Not a Material Increase in Capacity: Building

- She is not required to treat the amount paid to remove the drop-ceiling as a betterment to the building because it was not for a material addition or material increase in the capacity of the building structure , nor is it reasonably expected to materially increase the efficiency, strength, or quality of the building structure
- The effect on productivity and output of the building structure cannot be measured in this context, therefore these factors are not relevant in determining whether there is a betterment to the building structure

Example M
Material Addition: Building

- Theresa owns and operates a restaurant
- To better accommodate customers and increase customer traffic, she decides to add a drive-through area
- She pays to partition an area within its restaurant for
 - A drive-through service counter,
 - A service window with necessary security features
 - Build an overhang for vehicles, and
 - Construct a drive-up menu board

Example M
Material Addition: Building

- The drive-up menu board is § 1245 property that is a separate unit of property
- *An amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system*
- The amounts paid for the:
 - Partition
 - Service window and
 - Overhang are betterments to the building structure because they comprise a material addition (a physical expansion, extension, and addition of a major component) to the building structure
- Theresa must capitalize as an improvement the amounts paid to add the partition, drive-through window, and overhang
- In addition, she is required to capitalize the amounts paid to acquire and install each § 1245 property

Example N
Costs Incurred During Betterment

- Jeffrey owns a building that it uses in its service business
- To accommodate new employees and equipment, he pays to increase the load capacity of its electrical system adding a second electrical panel with additional circuits and adding wiring and outlets throughout the electrical system of its building
- To complete the upgrades to the electrical system, the contractor makes several holes in walls so Jeffery incurs costs to patch the holes and repaint of several walls
- *An amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system*

Example N: continued
Costs Incurred During Betterment

- The upgrading of the panel and wiring are for betterments to Jeffery's electrical system because they increase the capacity of the electrical system and increase the strength and output of the electrical system
- Jeffery is required to capitalize the costs of the upgrade to the electrical system as an improvement to the building unit of property
- In addition, he is required to capitalize the amounts paid to patch holes and repaint several walls in its building because these costs directly benefit and are incurred by reason of the improvement to the building unit of property

Questions?



Repair Regulations Webinars

- October 27, 2015 Buildings: Restoration : Noon to 1 pm CST
- October 28, 2015 Buildings: Adaptation : Noon to 1 pm CST
- October 29, 2015: Dispositions : Noon to 1 pm CST
- October 30, 2015 Other Remaining Issues of Importance : Noon to 1 pm CST

January
Getting Ready for Filing Season Webinars

- Free- Getting Ready for Filing Season – January 12, no CPE offered
- EITC Due Diligence – January 14 - \$35.00
- Identity Theft – January 19 - \$35.00
- 1 hour each CPE for EITC Due Diligence and Identity Theft

CALT Website

<http://www.calt.iastate.edu/>



Tour of the CALT Website



CALT Staff



Roger A. McEowen
CALT Director and is a Leonard Dolezal Professor in Agricultural Law
Email: mceowen@iastate.edu
Phone: (515) 294-4076
Fax: (515) 294-0700



Kristine A. Tidgren
Staff Attorney
E-mail: ktidgren@iastate.edu
Phone: (515) 294-6365
Fax: (515) 294-0700

CALT Staff



Kristy S. Maitre
Tax Specialist
E-mail: ksmaitre@iastate.edu
Phone: (515) 296-3810
Fax: (515) 294-0700



Tiffany Kayser
Program Administrator
Email: tkayser@iastate.edu
Phone: (515) 294-5217
Fax: (515) 294-0700
