Capitalization Rules: Building Systems

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Article 1 of our 4 part series

On December 23, 2011 the Treasury Department, together with the Internal Revenue Service, released further guidance related to taxpayers’ capitalization policies. It had been over two years since the service released guidance for taxpayers as it relates to their capitalization policies. These temporary regulations are in effect for amounts paid or incurred on or after January 1, 2012. Although the new regulations are primarily for clarification, there have been a few significant departures from the guidance released in 2008. This article will discuss the clarifications and departures as they relate to real property.

The cornerstone to understanding tax capitalization policies is to understand the concept of a unit of property. According to the 2008 regulations, an expense for a repair would need to be capitalized if it bettered, restored, modified, or extended the useful life of the unit of property. For real property, this unit of property was defined as the building and its structural components. This definition remains constant from the 2008 temporary regulations.

Under the 2008 temporary regulations, there was more flexibility for the taxpayer to expense repairs to a building or its components. For example, significant repairs to an elevator may better the elevator, but were not considered bettering or extending the usual life of the overall unit of property, the building. In this case, the repair to the elevator could be expenses rather than capitalized. However, the new regulations released in late 2011 make it more difficult for taxpayers to expense these repairs.

The new regulations require that the taxpayer evaluate the effects of the repair on the building and any specifically defined building system. The addition of these specifically defined systems makes the unit of property narrower than before. Generally, the larger the unit of property, the easier it was to expense a repair.

The temporary regulations added eight building systems:

- Heating, ventilation, and air conditioning systems;
- Plumbing systems;
- Electrical systems;
- Escalators;
- Elevators;
- Fire protection and alarm systems;
- Security systems; and
- Gas distribution systems.

If any repair is made to the previously mentioned building system, the taxpayer needs to evaluate if the repair has bettered the property, extended its useful life, or adapted it to a new use. If it is determined that one of these improvements has been made, the expense will need to be capitalized. At this time the taxpayer then has the option to write off a portion of the existing unit of property that was repaired.

For an example, we will use a typical fact pattern for residential real estate. A taxpayer placed a piece of residential real estate into service on January 1, 2005. The taxpayer chose not to perform a cost segregation study and has begun depreciating the building portion over 27.5 years. In February of 2012, the HVAC unit is overhauled and requires a new capitalized asset because of the aforementioned regulations. At this point the taxpayer will retroactively place a value on the old HVAC as of the date the building was originally purchased. The value of the old HVAC system, minus its share of depreciation, will be expenses when the new asset is capitalized.

The temporary regulations offer many examples and clarifications on this matter. Should you have any questions related to this topic, feel free to contact Mike Gracik (mgracik@keitercpa.com) or your Keiter Tax professional for further clarification.

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