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What is a Capital Expenditure?

IRS Changes Rules on Capital Expenditures Effective January 1, 2014!

The IRS published important and long awaited temporary regulations on December 23, 2011, that provide guidance on the application of sections 162(a) and 263(a) of the Internal Revenue Code that define what is a repair and currently deductible versus what must be capitalized and depreciated over its prescribed depreciable life. These new temporary regulations replace proposed regulations which were issued in 2008. Although they are called temporary regulations, they are the rules all taxpayers must abide by. The effective date of the temporary regulations was originally January 1, 2012; the IRS has changed the effective date to January 1, 2014.

These regulations are quite complicated and will require considerable research into your past practices. Do not hesitate! Begin this process now!

The temporary regulations are quite lengthy, detailed, and somewhat confusing -- but they included many examples which can help you better understand the Service's position.

This article will address some of the basic provisions of the regulations. Section 263(a) provides that no deduction ("immediate expense") is allowed for (1) any amount paid for new buildings or permanent improvements or betterments made to increase the value of any property or (2) any amounts expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. In addition, the 2008 regulations stated that capital expenditures included amounts paid or incurred to (1) add to the value, or substantially prolong the life of the property or (2) to adapt the property to a new or different use. Property is defined as a "unit of property".

So what is a unit of property? Prior to these new regulations, a building was a unit of property. Under the new regulations, a building and its building systems are each a unit of property. It further defines the building systems as the following nine systems:

1. HVAC systems
2. Plumbing systems
3. Electrical systems
4. Escalators
5. Elevators
6. Fire protection and alarm systems
7. Security systems
8. Gas distribution systems
9. Any other system identified in published guidance (whatever that means)

To better understand what this means, let's look at a couple of examples.

X owns an office building. The building has one HVAC system with 1 chiller. X replaces the chiller with a new chiller. Since the HVAC system is a unit of property, the chiller is a critical function in the operation of the HVAC system and is therefore a major component of the system; the cost of the chiller must be capitalized.

Under prior regulations, since the unit of the property was the building and not the HVAC system (as current regulations require), the chiller could have been expensed.

In this example, Y owns an office building. As part of the HVAC system, there are 10 independent roof top units. Each unit functions to heat and cool a different part of the building. As a part of doing routine maintenance to the units, it is determined that Y must replace 2 of the 10 units. Y replaces the 2 units with similar units. Since the units by themselves do not comprise a major component or a substantial part of the physical structure of the HVAC system, Y can expense the costs of these units.

In example 2, had you replaced 8 of these units, this would most likely be deemed to be a major component and therefore the units would need to be capitalized.

What is a Capital Expenditure?

The IRS recently issued temporary regulations which clarify the tax rules relating to repairs and maintenance vs. capital improvements; these regulations apply to leased property as well.

The temporary regulations did not change the rule that a taxpayer can amortize the cost to acquire leasehold (not a leasehold improvement) over the term of the lease.

What the temporary regulations did clarify (which has been the rule since 1986) is that a taxpayer must amortize leasehold improvements under the cost recovery provisions of the Internal Revenue Code applicable to the improvements without regard to the term of the lease.

Therefore, if you make an improvement to your leased property and you have a 5-year lease, you must amortize the improvement over 15, 27.5 or 39 years, depending on what life is stated in the Code at the time. As we know from recent history, the IRS has changed lives for amortizing leasehold improvements several times from 39 years for commercial property and 27.5 years for residential property, to 15 years.

The following are some very important and significant changes the IRS made to leased property improvements. A lessee improvement involves the acquisition or production of a new and distinct interest in property, and this interest is often different from the underlying leased property. This means that the improvement is a new unit of property separate and distinguishable from the leased property being improved, rather than an improvement to the building.

In the case of a lessee, the unit of property is the portion of the building leased (such as office, floor or certain square footage). For example:

Lessee rents one floor in an office building that houses one HVAC system. After 2 years in the space, the lessee needs to replace the compressor to the HVAC system. Since the HVAC system for lessee's space is a unit of property and since the compressor is a major component to the HVAC system, the lessee must capitalize the costs of the new compressor.

What about the lessor? A lessor must capitalize all amounts paid directly or indirectly through a construction allowance to the lessee to improve a unit of leased property where the lessor is the owner of the improvement for tax purposes. In addition, a lessor must capitalize all amounts paid by the lessee to improve a unit of leased property where the lessee's improvement constitutes a substitute for rent. This requirement merits special attention when writing your leases.

A lessor improvement, however, is treated as any other owner improvement and therefore is not a new unit of property. In the hands of the lessor, the unit of property is the building and its building systems. Therefore, if the improvement is not considered a significant addition to the property, it may not be expensed.

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New temporary regulations issued by the IRS regarding capital expenditures also explains the treatment of materials and supplies. Many people in the industry believe that materials and supplies are to be expensed at the time of purchase; however, this is not in accordance with Federal income tax regulations.

Section 1.162-3 of the regulations states that a taxpayer carrying materials and supplies on hand (i.e. spare parts) should include in expenses the charges for materials and supplies only in the amount that are actually consumed and used in operations during the taxable year.

Under the new regulations, materials and supplies are components that are purchased to maintain, repair or improve a unit of tangible property and are not purchased as part of any single unit of property. Currently, there is a de minimus rule that allows a taxpayer to expense any materials or supplies that cost no more than $100.

The IRS has 3 specific optional methods which must be used to expense replacement components or temporary space parts.

- Method 1: Capitalize the replacement components or temporary spare part as a unit of property and depreciate it.
- Method 2: Defer the cost and expense the cost when the part is used.
- Method 3: Expense the replacement spare part when it is installed and assign a fair market value to the used part which you remove from the unit of property to repair it; include that fair market value in income and add to this value the cost to repair the part. When this repaired replacement part is then used, it is expensed. If this option is chosen, then it must be used for all replacement spare parts.

So what does this all mean? Let's look at an example and see what options are available.

Assume you own a 200-unit apartment building. Each unit has an air conditioner in the living room, which you supply to your tenants. You purchase 25 compressors at a cost of $300 each to keep as spare parts. Further assume that during 2012, you used 5 of these compressors to replace 5 non-functioning ones. At the time you purchased the 25 compressors and spent $7,500, you can either defer the cost (record as prepaid supplies) or you can capitalize them and depreciate them over five years.

If you opted for the deferral when you used 5 of the compressors during 2012, you can now expense $1,500. With the third option, if you will repair the old compressors, then you would expense $1,500 for the use of the 5 compressors. Assuming the value of each of the old compressors was $150, you would record income of $750 since this is a replacement spare part. You will not expense the entire cost of the part until you ultimately dispose of it.

New Capitalization Rules Address "Betterment" and Restoration

In order to determine whether the work done to a building needs to be capitalized, you must apply the rules of determining whether the costs are incurred for a betterment or restoration to the building or its systems or to adapt the building to a new or different use.

What is a betterment?

The new temporary regulations define a betterment as an improvement that either:

1. Ameliorates a material condition or material defect that existed prior to the acquisition of the property or during the construction phase;
2. Results in a material addition to the unit of property; or
3. Results in a material increase in the capacity, productivity, efficiency, strength or quality of the unit of property.

To determine whether the expenditures resulted in a betterment to the property, you must compare the condition of the property after the expenditure is made to the condition of the property immediately prior to the circumstances necessitating the expenditure

Here are three examples that will clarify the IRS's position on what is a betterment.

Example 1: X purchases a retail store location which once housed a gas station. The land contained underground gasoline tanks left from the previous tenant. Two years later X finds that a tank leaked and contaminated the soil. X was not aware of the leak at the time X purchased the property. The remediation costs are considered a betterment since they ameliorate a material condition that existed prior to X's acquisition of the property.

Example 2: Y owns a building that contains some asbestos insulation. Y determines that some of the insulation is damaged and therefore needs to be removed and replaced with new non-asbestos insulation. Although it's been determined that the asbestos insulation is unsafe, it does not constitute a betterment, since it was not a pre-existing or material defect of the building

Example 3: Z owns a building which has a wooden shingle roof. During a storm, a number of the shingles were damaged or blown away. Z replaces the wooden shingles with new wooden shingles. Since after the shingles were replaced the condition of the building was exactly the same as it was before the storm (the event necessitating the expenditure), the replacement of the shingles is not deemed a betterment to the property and Z therefore does not have to capitalize the costs to replace the shingles.

Assume the same facts in the above example, but instead Z replaces the wooden shingles with asphalt shingles that are maintenance free, have a better fire rating and a 50-year warranty. Since the new shingles are of better quality than the old wooden shingles, the costs Z incurred to replace the wooden shingles with the asphalt shingles are deemed a betterment and therefore the costs incurred by Z must be capitalized.

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Cost Segregation: Important Part of New Capitalization Rules

The new temporary regulations revise the definition of a disposition and allow a taxpayer to treat the retirement of a structural component of a building as a disposition of property. When a building component is disposed of, the taxpayer can take a deductible loss for the book value (cost minus accumulated depreciation) of the asset at the time of disposition. In order to take the loss you must be able to determine what the book value of the structural component you are disposing of is.

If you had a cost segregation study done at the time you acquired the property, it should have been prepared in enough detail to include the cost allocated to the structural components, i.e. elevators, HVAC systems, roof, boilers etc., and not just the assets that qualified for a shorter deprecation life.

If you aren't as fortunate to have a cost segregation study with such detail, the IRS allows you to use a reasonable method to determine the book value of the component, provided you apply the same methodology consistently among all structural components. Some methods which the IRS deems reasonable are the use of industry averages, construction costs for comparable properties, cost records, statistical sampling, or any combination of these methods.

This change in the regulations is more significant than you may think. Prior to this change, if you replaced the roof on your building, you were potentially depreciating two roofs at the same time: the one that you purchased at the time you acquired the property and the replacement roof. Since the depreciable lives of buildings are 27.5 years for residential property and 39 years for commercial property, it is very likely that you have been depreciating two or maybe even more of the same structural components.

This change in the regulations makes cost segregation studies even more valuable. However, when engaging a professional to do cost segregation study, be sure that they will determine the cost of the major structural components of your building and not just the components that qualify for shorter lives.

The temporary regulations are effective for years beginning January 1, 2014. However, all taxpayers who did not follow these regulations prior to January 1, 2014 must file a Form 3115 with their tax returns, electing to make a change in accounting method. The IRS has said that this election will be automatically accepted and does not need prior IRS approval, if the election is made with a 2014 income tax filing.

More importantly, when preparing the Form 3115, you must compute the cumulative effect of not complying with the regulations in the past and report a Section 481(a) adjustment on your tax return and on Form 3115. Therefore, if you previously expensed costs that under the regulations should have been capitalized, you will recognize income equal to the difference between the amount you expensed and the amount of depreciation you should have taken through the date of the election to change the accounting method.

These regulations are new, complex, and should be addressed with your certified public accountant to see how you may be impacted.

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