To Capitalize or to Expense?
Interpreting the IRS’s New Rules

by Jennifer Schmidt, Senior Manager, Accounting Methods, and Michael Hall, Partner, Real Estate Group

The IRS has issued new regulations for the capitalization and expensing of costs incurred to acquire, produce, repair, or improve real and personal property. And although they’re officially temporary, these new rules—the culmination of an almost eight-year project—apply to tax years beginning on or after January 1, 2012.

The new regulations are particularly significant for the real estate industry, because this issue not only affects the lifeblood of the property business but has also been a major gray area, and a subject of litigation, in the past. In that light, let’s examine three key aspects of the new regulations and their potential impact on real estate owners, operators, and developers.

A Revised Definition of Unit of Property

In the past the whole building was often considered the unit of property. This meant upgrade expenditures were more likely to be considered deductible repairs, because they were proportionally small compared with the larger unit of property.

The new regulations make the unit of property much smaller, breaking it down into the building structure and individual building systems such as HVAC, plumbing, electricity, elevators, gas, and security. As a result, more upgrade expenditures will be seen as capital improvements.

Let’s say a portion of an HVAC system is replaced in year 15 of a 39-year depreciable life. In the past, when the old whole-building unit-of-property definition held sway, this upgrade might well have been expensed as a deductible repair. Under the new rules, the taxpayer will capitalize the new HVAC system and can identify the remaining basis of the original HVAC system and write it off, avoiding having duplicate depreciable assets on the company’s books.

Repair or Improvement?

This has been a controversial issue, because the cost of a repair can be treated as a deduction in the tax year the repair is made, which generally is more attractive for the taxpayer. The cost of an improvement, meanwhile, must be capitalized and depreciated over the life of the asset—39 years for a commercial building.
The new regulations add clarity, stating that an upgrade expenditure will generally be considered an improvement if it results in the unit of property’s betterment, restoration, or adaption to a new or different use. The table below defines these three terms.

Companies that have been overly aggressive on repairs in the past will have to reevaluate those positions and may need to recapitalize certain costs to comply with the new regulations. Doing so will allow those taxpayers to receive audit protection for prior years and to spread any positive adjustment to income over a four-year period.

**Which Costs Must Be Capitalized?**

One result of the new regulations is that we now have increased lucidity when it comes to understanding which costs can be capitalized as real property is being acquired. The general rule is that expenditures made when a company is deciding whether to acquire real property, or which property to acquire, don’t have to be capitalized. However, if expenditures are deemed to inherently facilitate the acquisition of a property, they must indeed be capitalized.

Put another way, in more operational terms, if a company spends money doing a market analysis prior to acquisition, it wouldn’t have to capitalize the cost. But if it hires lawyers, accountants, and bankers to facilitate a specific property acquisition, those costs would have to be capitalized.

**Where to Go from Here**

The IRS wants to encourage compliance with the new regulations, and to that end it’s offering taxpayers a host of ways to get automatic consent for accounting method changes. For example, if taxpayers make their method change within the first two tax years the new regulations are effective (years beginning January 1, 2012), they can gain automatic consent without having to observe the normal scope limitations associated with accounting method changes.

However, it’s important to note that automatic consent is granted assuming taxpayers follow the IRS’s accounting method change procedures for each item being changed. (There are 19 changes in all.)

Clearly, the new regulations are sweeping and complex. To fully understand them, comply with

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<th>IMPROVEMENT TYPE</th>
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| **Betterment**   | • Ameliorates a material condition or defect  
|                  | • Provides a material addition  
|                  | • Adds a material increase in capacity, productivity, or efficiency  |
| **Restoration**  | • Replaces a component for which the taxpayer has deducted a loss  
|                  | • Replaces a component for which the taxpayer has taken into account the adjusted basis in realizing a gain or loss on its sale or exchange  
|                  | • Repairs damage for which the taxpayer has taken a basis adjustment as a result of a casualty loss  
|                  | • Returns the unit of property to its ordinarily efficient operating condition  
|                  | • Pays for the rebuilding of the unit of property to a like-new condition after the end of its depreciation period  
|                  | • Replaces a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property  |
| **Adaption**     | Changes the use of the unit of property in a way that varies from its intended ordinary use at the time it was originally placed in service by the taxpayer |
them, and take advantage of the opportunities they offer, companies need solid, strong, and sophisticated tax advisors. They must also ask the right questions about the costs they're now capitalizing and how they decide whether to capitalize or expense in the future.

In addition, companies must adopt a fresh mindset, especially in light of the new unit-of-property definition. A large part of this requires breaking out costs for individual systems and components on the front end. This will enable companies to track basis costs and save records for the future, when follow-up repairs or improvements may be necessary and tax implications once again become a factor.

Jennifer Schmidt leads the firm’s tax accounting methods practice and has over 15 years of experience helping companies with accounting methods planning.

Michael Hall provides tax and business planning services to commercial real estate developers and leads the firm’s Real Estate practice in Washington State.

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