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IRS temporary regulations relating to capitalization vs. repair of real property costs

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In late 2011, Treasury and IRS released temporary regulations relating to the deduction and capitalization of amounts paid to repair, maintain, and improve property -- including real property. This article will focus on the general aspects relating to real property.

These rules significantly change a taxpayer's analysis as to whether certain current costs relating to real property can be deducted or are required to be capitalized. The rules are complex and expansive. They introduce new concepts, including the concept of unit of property, that in some ways contradict prior IRS rules and long standing practice. Taxpayers need to evaluate their present policies to determine whether they need to make changes in policy to conform to these new rules.

The temporary regulations significantly change principles for capitalization of costs as contained in prior rules. In the case of buildings, instead of comprising the entire building a unit of property has been divided into smaller units, including the building structure and certain building systems, e.g. HVAC, electrical, and plumbing systems. As a result of this division, when applying the new capitalization principles it appears that costs are more likely to result in capitalization as betterment, restoration, or new use -- with the cost recaptured through depreciation rather than current expense.

A cost is treated as a capital expenditure if it results in an improvement to the building structure or to any of the building systems. By way of example, if a taxpayer replaces an entire roof, the cost will most likely be considered an improvement to the building unit of property. Similarly, if a taxpayer improves the HVAC system, the cost will also constitute an improvement to the building unit of property.

There may be benefits to taxpayers under these rules. For example, it appears that a taxpayer will be able to deduct the adjusted basis of its original roof in the year that he replaces the roof rather than being required to continue to depreciate the old roof. One drawback to the new rules is that IRS and Treasury did not retain the prior safe harbor that allows a current deduction for the cost of "routine maintenance" activities relating to buildings. It appears that both IRS and Treasury believe that the prior safe harbor rules were being used to deduct certain project costs which they believe should have been capitalized. In lieu of the safe harbor, taxpayers will need to analyze whether costs are for the betterment or restoration of a building. The regulations include detailed rules and a number of examples to assist taxpayer in this analysis.

These rules are effective for tax years beginning on or after January 1, 2012. Any changes made to comply with these rules will necessitate an automatic change in method of accounting on a taxpayer's 2012 tax return and may require an adjustment for prior depreciation.

On November 20, 2012, IRS released Notice 2012-73 stating that the Treasury and IRS will be issuing final regulations regarding the deduction and capitalization of expenditures in 2013, and it is anticipated that the final regulations will contain changes from the temporary regulations previously released in December 2011 (the subject of this article).

The final regulations will apply to taxable years beginning on or after January 1, 2014, but will permit taxpayers to apply these final regulations to taxable years beginning on or after January 1, 2012. In addition, Treasury Department will soon issue a Decision amending the temporary regulations to apply to taxable years beginning on or after January 1, 2014 (rather than January 1, 2012) although taxpayers can choose to apply the temporary regulations for taxable years beginning on or after January 1, 2012.

With year-end approaching, it is important for taxpayers to consult their tax advisors to determine if they need to make any changes to their accounting/tax capitalization and expense policies.

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