

Ask the Experts

New Internal Revenue Service capitalization rules and the effect on real estate entities

Ryan Immitt



Mayer CPAs

After more than a decade of debate and revision, the Internal Revenue Service issued final regulations containing rules governing repairs and capitalization. These regulations, effective January 1st, contain guidance on new rules regarding capitalization vs expense of costs incurred in acquiring, maintaining, repairing, and improving tangible and real property. While many of these concepts have always been part of the Internal Revenue Code, the intention of the Internal Revenue Service, through these regulations, is to remove some of the subjectivity by making it clearer that capitalization will be required in many cases. This article provides an overview of how the new regulations can affect a business entity that owns and operates real estate assets.

The final regulations offer clarification as to whether an expenditure is a deduction or a capitalized fixed asset subject to recovery through depreciation over time. Each expendi-

ture is evaluated differently based on the specific facts and circumstances. An improvement made to a building must first be evaluated by what is referred to as the "BAR Tests." An expenditure must be capitalized if it results in a betterment to the property, an adaptation of the property to a new or different use, or a restoration of the property. Amounts that do not result in an improvement under the capitalization standards can generally be expensed as a repair.

In determining whether an expenditure should be capitalized or expensed, the "unit of property" concept is important. The final regulations require that a taxpayer apply the improvement standards separately to the primary components of the building. The following components have been identified as being independent units of property separate and distinct from the building itself: (1) heating, ventilation, and air conditioning systems; (2) plumbing systems; (3) electrical systems; (4) all escalators; (5) all elevators; (6) fire protection and alarm systems; (7) security systems; (8) gas distribution systems; and (9) any other systems identified in published guidance. This new separation of a building structure into these smaller components may cause what was previously considered a deductible

repair to now being treated as a capital expenditure. This is because the cost of repair to a component compared to

building in service. The second safe harbor provision is the small taxpayer safe harbor election and allows

safe harbour election provides that a taxpayer can establish a capitalization threshold policy of \$5,000 if they

The final regulations offer clarification as to whether an expenditure is a deduction or a capitalized fixed asset subject to recovery through depreciation over time. Each expenditure is evaluated differently based on the specific facts and circumstances. An improvement made to a building must first be evaluated by what is referred to as the "BAR Tests." An expenditure must be capitalized if it results in a betterment to the property, an adaptation of the property to a new or different use, or a restoration of the property.

the separate cost of that component is more significant than when compared to the cost of the building as a whole.

Included in the final regulations are multiple safe harbor election and provisions. The first is the safe harbor provision for routine maintenance. Under this safe harbor provision, taxpayers may be able to deduct expenditures for activities that the taxpayer reasonably expects to occur more than once during the class life of the asset. The new regulations expand this safe harbor to buildings as long as the activity occurs more than once during the 10-year period beginning at the time the taxpayer places the

certain qualifying taxpayers to not apply the improvement rules to an eligible building property. A qualifying small taxpayer is a taxpayer whose average annual gross receipts for the three preceding taxable years are \$10 million or less. Eligible building property includes buildings and leased buildings with an unadjusted basis of \$1 million or less. The total repairs, maintenance, improvements, and similar activities performed on the building cannot exceed the lesser of: (1) \$10,000 or (2) 2% of the unadjusted basis of the building. The last safe harbour provision is the de minimis safe harbour election. This

have an applicable financial statement prepared by an independent certified public accountant (otherwise \$500 threshold if there is no applicable financial statement).

While many businesses will be affected, the real estate sector will be especially impacted as these new regulations will require many real estate entities to capitalize and depreciate over time expenditures that they have previously treated as current expense.

Ryan Immitt is a tax manager at Mayer CPAs LLC, Syosset, N.Y.

Commercial & Residential Real Estate Expertise

Assistance with obtaining Performance Bonds

Cash Flow Strategies

Contractor Internal Control

Cost Segregation

Percentage of Completion & Completed Contracts Method

Sales, Use & Other Taxes

Software System Selection

Succession Planning

MAYER
ACCOUNTANTS • BUSINESS ADVISORS

499 7th Avenue, Floor 20N | New York, NY 10018 | 212-631-9500

99 Sunnyside Blvd., Suite 101 | Woodbury, NY 11797 | 516-921-8900

www.mayercpa.com