The IRS issues final "Repair and Capitalization Regulations" - Including the concept of UOP

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The IRS recently issued final "Repair and Capitalization Regulations." These regulations govern when taxpayers must capitalize and when they can deduct their expenses for acquiring, improving, maintaining, repairing and replacing tangible property. Included in the regulations is the concept of Unit of Property (UOP) which is targeted toward the real estate industry. The regulations generally defined a UOP as consisting of all components that are functionally interdependent

Before the regulations, a purchaser of real property would generally allocate the cost of the property between land and building. Other purchasers have performed Cost Segregation Studies which allocate the purchase price between short recovery period assets (i.e. equipment) and long recovery period assets(i.e. the building itself). The concept of UOP takes the extra step of allocating the cost of the building into its components by separating out the cost of specified systems. These systems are:

* Heating, ventilation and air conditioning systems (HVAC).
* Plumbing systems.
* Electrical systems.
* Escalators.
* Elevators.
* Fire protection and alarm systems
* Gas distribution systems.
* Any other systems identified in published guidance.

The depreciable life of the systems remains the same as the building. 39 years for commercial property and 27.5 years for residential property.

Under prior regulations, the determination of whether an expenditure was required to be capitalized or written off as an expense was measured in its relationship to the building as a whole. Did the expenditure extend the life of the building or increase its value? If the answer was yes, the expenditure was capitalized, if not, expensed.

The ultimate result of the regulations is to change the basis of measurement from the entire building to the UOP. This increases the likelihood that expenditures will need to be capitalized as an improvement. For example, if a taxpayer had an expenditure related to its roof, the UOP to use in determining if it is a capitalized improvement or a deductible repair is the building since the roof is not included in one of the separate building systems. For repairs to several of the building's rooftop air conditioner units, however, the appropriate UOP to use in determining if it is a capitalized improvement or a deductible repair is the HVAC system (a smaller unit-of-property than the building). Repairing a portion of the roof would not be considered a major expenditure in relation to the building as a whole and thus could be expensed as a repair, but repairing an HVAC problem could be a major component of that system and would be capitalized and depreciated over its useful life.

On the positive side, UOP allow for the partial disposition of assets not available prior to the regulations. Under the prior rules, if a building installed new elevators, the cost of the elevators would be capitalized and depreciated over thirty nine years for a commercial building. The depreciation of the rest of the building would remain unchanged. Now the UOP related to the replaced elevators can be written off when the new elevators are put into service and a Section 1231 loss can be taken for the undepreciated portion of the old elevator. Taxpayers can use any reasonable method to calculate the basis of the various units of property's comprising their real estate including:

* Cost Segregation Studies.
* Producer price index (PPI) roll back methods.
* Factorial Comparisons.

The determination of the appropriate UOP is the first step in determining the need to capitalize an expenditure related to real property. Once the UOP is determined, the new improvement standards from the final regulations can be applied. Many real estate businesses will need to file an accounting method change (filing Form 3115) to adopt the new UOP rules as they apply to their buildings. Fortunately, this method change can be executed alongside most other accounting method changes required by the final tangible property regulations. Businesses with less than $10 million of receipts or less than $10 million in assets do not need to file Form 3115 to adopt the new regulations.

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