



Temporary IRS regulations regarding IRC Sections 162(a), 263(a) and unit of property concept

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On December 23, 2011, the Internal Revenue Service issued temporary regulations which provide guidance on applying Code Sections 162(a) and 263(a) for amounts paid to acquire, produce, or improve tangible property. The regulations are effective for tax years beginning after December 31, 2011. The application of the regulations will lead to another set of tests and questions regarding the ever present question in tax accounting of whether to expense or capitalize a cost related to property.

Probably the most important concept discussed in the regulations which is applicable to our real estate clients concerns the "Unit of Property" concept. A unit of property (UOP) for real and personal property, other than buildings, is defined as consisting of all the components of the property that are functionally interdependent. For example, an electric golf cart chassis cannot function without a battery, so the two parts belong to the same unit of property. The smaller the UOP, the more likely it is that costs incurred in connection with that UOP will have to be capitalized.

For buildings, each building and its related structural components are considered one UOP. Amounts are treated as paid for an improvement to a building if they improve either the building structure or any designated "building system." The building system concept is a new one and consists of one of the following nine components: HVAC systems; plumbing system; electrical systems; escalators; elevators; fire-protection and alarm systems; security systems; gas distribution systems; and a catch-all category of other structural components identified in published IRS guidance that aren't part of the building structure and are specifically designated as a building system.

Since each building system is a separate unit of property, this leads to a discussion of the rule that the smaller the unit of property, the more likely costs will be capitalized. For example, a \$3,000 expenditure related to an elevator which extends the elevator's useful life, may have in the past been expensed as immaterial relative to the overall cost of the building. However, now that the elevator as a separate building system must be looked at as a separate UOP, it could be required to be capitalized.

Under the new regulations as a general rule, all the costs which facilitate the acquisition or production of tangible real or personal property are required to be capitalized. There are exceptions for employee compensation and overhead costs. Investigatory expenses for acquiring real estate do not have to be capitalized unless the expenses are deemed to be "inherently facilitative." Inherently facilitative expenses fall into one of the following 11 categories: shipping, moving or appraising property; application fees and architectural, engineering, environmental and inspection services; broker and appraisal fees, and services provided by a qualified intermediary in a like-kind exchange. An example of an investigatory expense which could be expensed would be a consulting firm hired

to by a retail operation to recommend an area of a city for an additional location as this expense is both investigatory and not on the inherently facilitative list.

A taxpayer is required to capitalize all amounts paid to acquire or produce a unit of real or personal property unless the "material and supplies rule" applies or the "de minimis rule" applies. The term "materials and supplies" is defined by the regulations as tangible property used or consumed in the taxpayer's business operations that is not inventory and that falls within any of the following categories: "(1) It is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property; or (2) It consists of fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in taxpayer's operations; or (3) It is a unit of property with an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations; or (4) It is a unit of property with an acquisition cost or production cost of \$100 or less or (5) It is identified in published IRS guidance as materials and supplies eligible for the rules in Reg.

Â§ 1.162-3T."

The implementation of the regulations to your real estate activities will require much planning. Accordingly, please consult your tax advisor on how best to implement the changes to your accounting procedures.

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