



Got real estate? New rules apply to you!

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In December 2011, the Treasury Department published temporary and proposed regulations (temporary regulations) that provide guidance on the amounts paid to acquire, produce or improve tangible personal property. The temporary regulations also address the treatment of real property acquisitions and improvements. In November 2012, the Treasury Department announced that they expect to issue final regulations of these subjects during 2013. It is anticipated that these final regulations will apply to tax years beginning on or after January 1st, 2014 with early adoption permissible. Many of the provisions of the temporary regulations are expected to be published without change in the final regulations. The following is a brief overview of select provisions of the temporary regulations that are not expected to change and how they specifically affect real estate owners, developers and related professionals. This article is not intended to address all of the aspects covered in the temporary regulations.

Acquisition of Property: The temporary regulations retain the general rule that the purchase of real property must be capitalized. This includes amounts paid for new buildings, leasehold property and land. More importantly, the temporary regulations also address and clarify the capitalization of costs paid to facilitate the acquisition of real property.

Costs To Facilitate The Acquisition of Real Property: The temporary regulations state that a taxpayer must capitalize all costs which are "inherently facilitative". Inherently facilitative costs are amounts paid in the process of investigating or otherwise pursuing an acquisition of property. In other words, a taxpayer must capitalize amounts paid that help facilitate the purchase of a specific property from appraisal to signing. These property-specific costs include appraisal fees, tax and legal advice, preparing bids and offers, drafting the sales contract, title searches, broker commissions and 1031 exchange services, amongst others. These inherently facilitative costs are to be capitalized even if the subject property is not acquired. Conversely, there is a special rule that allows the taxpayer to deduct certain costs if they relate to the activities performed in the process of determining whether or not to acquire real property or which real property to acquire.

Example: A retailer, X, is assessing whether to purchase a new store in City A. In July, Year 1, X incurs costs for a development firm to study City A and perform market surveys, evaluate zoning and provide preliminary recommendations on site selections. In November, Year 1, X hires an appraiser to appraise two of the recommended property sites. In January, Year 2, X decides to acquire one of the two sites.

Outcome: X is not required to capitalize the development firm's fees as they were paid to determine whether or not to acquire real property and which property to acquire. X is required to capitalize the appraisal fees for each of the two properties in Year 1. In Year 2, X includes the appraisal fees relating to the acquired property in the acquired property's basis. X is able to deduct the appraisal fees related to the property not acquired using Section 165 rules.

Improvements to Property: The temporary regulations state that a taxpayer must capitalize amounts paid to improve a "unit of property" (defined below). A unit of property is improved if the amounts paid (1) result in betterment to the unit of property, (2) restore the unit of property or (3) adapt the unit of property to a new or different use.

What is a Unit of Property? In the context of real property, each building and its structural components (excluding building systems, defined below) are considered a single unit of property. A building's structural components include walls, floors, paneling, windows, permanent coverings, etc. Building systems are considered separate units of property and are significant structural components of a building that contribute to its function, including HVAC systems, plumbing systems, electrical systems, elevators, security systems and other business systems identified by the IRC. The temporary regulations explain that a building system encompasses all related components which are functionally interdependent on one another (i.e. the working of one component is contingent on the working of another). For instance, the plumbing system includes pipes, drains, valves, sinks, toilets, pumps, etc. If one of these components were to break the system would leak thus rendering the entire system inoperable.

When is a Unit of Property Improved? Under the temporary regulations a taxpayer must apply the improvement rules separately to the building (including its structural components) and to each of the building systems. By applying the improvement rules to a specific building system, an insignificant repair in relation to the building may be considered an improvement (capitalized) if it is significant to the specific building system.

Example: A building has a HVAC system that consists of five roof mounted units. The entire HVAC system is not functioning properly because two of the roof mounted units are broken. The repair of these two units is considered an improvement as it restores the building system to operating condition.

Betterment of Property: Under the temporary regulations, if an amount paid results in a betterment to a building's structure or any building system, the amount must be treated as an improvement to the building. The amount paid results in betterment if it (1) fixes a material condition or defect, (2) results in a material addition or (3) results in a material increase in capacity, productivity, efficiency, strength or quality.

Example: Taxpayer X owns a retail store which recently lost a number of wooden shingles on the roof as the result of a storm. The absence of shingles is resulting in leaks and the taxpayer contracts a firm to fix the problem. The contracting firm recommends either similar wooden shingles or superior asphalt shingles. The taxpayer requests that the firm replace all of the roof's shingles with asphalt shingles.

Outcome: The installation of asphalt shingles is considered a betterment to the building's structure since asphalt shingles have increased strength and quality as compared to the wooden shingles. If the taxpayer chooses to replace all of the shingles with comparable wooden or composite shingles, it would not result in betterment.

Restoration of Property: An amount paid to restore a building or any of its building systems is considered an improvement and should be capitalized. An amount paid qualifies as a restoration if it (1) returns the building's structure or any of the building systems to ordinary efficient operating condition if the property is no longer functioning, (2) is for the replacement of a component(s) that performs a discrete and critical function to a building's structure or its systems or (3) replaces property to which the taxpayer has properly taken into account the adjusted basis when realizing

gain or loss resulting from the sale or casualty of the property.

Example: Taxpayer X owns a retail store and discovers a leak in the roof. A contractor inspects the leak and discovers the rafters and sheathing have rotted and the roof membrane is substantially torn. Taxpayer X decides to replace the entire roof.

Outcome: The new roof is considered an improvement as it restores the entire roof which performs a discrete and critical function to the building's structure. If just the roof membrane was replaced, while it does affect the function of the building, it would not be considered an improvement because it did not replace a component that performed a discrete and critical function to the building's structure as a whole.

Adapt A Property To A New or Different Use: Taxpayers must capitalize amounts paid to adapt a unit of property to a new or different use. The adaptation is considered a new or different use if it is not consistent with the taxpayer's intended ordinary use of the property.

An example would be if a taxpayer converted a portion of their manufacturing facility into a showroom in order to display their products. The costs to convert this portion of the building would be capitalized. Conversely, if the taxpayer refinished the manufacturing facility's floors and painted all of the walls, this would not constitute a new or different use of the property and may be deducted. When determining whether amounts paid constitute a facilitative cost or an improvement, each situation must be evaluated separately with consideration placed on all facts and circumstances. Please consult with your tax advisor when applying the above temporary regulations to your particular situation.

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