

Temporary IRS Regulations May Generate Opportunities for Property Owners

New Temporary Treasury Regulations Affecting Deduction and Capitalization of Tangible Property Expenditures

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IRS to hold Public Hearing on May 9, 2012

Many of our clients who own, operate and lease real property have been taking advantage of relatively low interest rates and available financing to replace and upgrade building components and building systems. From a marketing perspective, this trend is being driven by efforts to make buildings more desirable to a broader range of potential tenants in an extremely competitive real estate market. In many instances, building owners are increasingly finding it necessary to completely remove a former tenant's leasehold improvements and replace them with new and state-of-the-art improvements to attract incoming tenants and retain existing tenancies.

In making such improvements and upgrades, building owners should be mindful of new temporary regulations issued by the Internal Revenue Service (IRS) which govern the deduction and capitalization of costs incurred by taxpayers who "acquire, produce or improve" tangible property. Prior to adopting these as final regulations, the IRS will hear comments at a public hearing scheduled for May 9, 2012.

It is particularly noteworthy that the temporary regulations now allow a building owner to in effect accelerate depreciation by allowing them to recognize a loss upon the retirement of a building component or building system - whereas prior to the enactment of these temporary regulations, the building owner was required to continue the depreciation schedule *after* the retirement of the component or system.

Effective for tax years beginning on or after January 1, 2012, the temporary regulations will have the effect of limiting deductions for the expenses of improving or replacing "building systems," identified in the regulations to include the following:

- HVAC systems
- Plumbing systems
- Electrical systems
- Escalators

Published Articles (Cont.)

- Elevators
- Fire protection and alarm systems
- Security systems
- Gas distribution systems
- Any other systems identified by the IRS in published guidance

Building and/or system improvements must now be capitalized, rather than deducted, if the improvement results in a “betterment” to the building and/or system. A “betterment” is defined as an amount spent which (i) ameliorates a material condition or defect, (ii) results in a material addition (including enlargement, expansion or extension), or (iii) results in a material increase in capacity, productivity, efficiency, strength, quality, or output.

It is important to note that not all improvements will be considered betterments that must be capitalized. The temporary regulations contain some important exceptions permitting certain improvements to be expensed--rather than capitalized. For example, where a building component or one of its systems is improved because the replacement parts needed to repair it are unavailable (possibly as a result of technological advancements or product enhancements), the replacement of the part with an improved, but comparable, part will not, by itself, result in a betterment requiring capitalization, and instead permit the part to be expensed.