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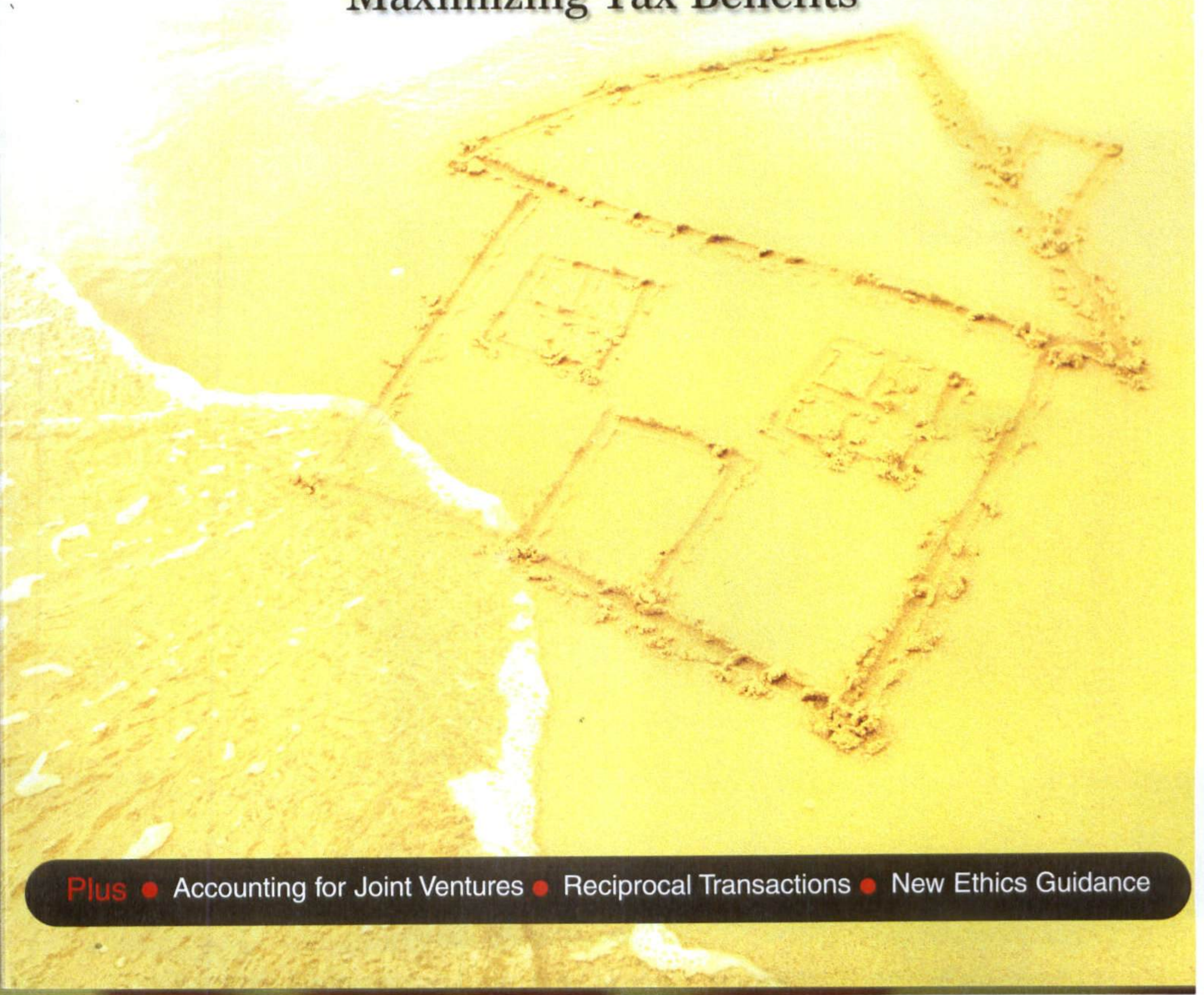

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Tracking Capital Expenditures

Exploring Cost Segregation Studies and Related Temporary Regulations

By Mark Vorkapich

On December 23, 2011, the U.S. Department of the Treasury published temporary regulations (TD 9564, *Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property*) that affect all taxpayers who acquire, produce, or improve tangible property. The regulations, which expanded and clarified the rules surrounding capital expenditures under Internal Revenue Code (IRC) section 263(a), included many changes, such as the following:

- They refined the definition of "unit of property."
- They allowed dispositions of a building's structural components.
- They provided a facts-based approach for determining whether work performed on a building or leasehold improvements should be considered a deductible repair or a capital expense.

In addition, these regulations have changed the methods for tracking capital expenditures. The following discussion will explore the effects of the temporary regulations, which have an effective date of January 1, 2014. Taxpayers can elect to apply the temporary regulations for 2012 or 2013.

Unit of Property

An engineering-based cost segregation study has traditionally been used to identify and reclassify property that is included in the cost of the building but is not a building component and can be depreciated over shorter recovery periods. These breakdowns follow the modified accelerated cost recovery system (MACRS).

Under the new regulations, for all purposes other than repair, a building and its structural components are considered a single unit of property. The qualitative and quantitative information already contained in an engineering-based cost segregation study can be used to readily identify all of these assets.

A unit of property consists of a building's structure and a building's systems, including—

- heating, ventilation, and air conditioning (HVAC) systems;
- plumbing systems;
- electrical systems;
- all escalators;
- all elevators;
- fire protection and alarm systems;
- security systems;
- gas distribution systems; and
- other structural components identified in the temporary regulations.

The temporary regulations have established a qualitative framework to track expenditures. The replacement or improvement of these components is referred to as a "capital improvement."

Classifying Capital Expenditures

A capital expenditure, as defined by the regulations, refers to any betterment, restoration, or adaptation of a unit of property. A "betterment" corrects a material condition or defect that existed prior to the taxpayer's acquisition of the property. In addition, a betterment is an activity that results in a material addition or increase to the property's capacity, productivity, efficiency, strength, quality, or output. A "restoration" is the replacement of any major component or substantial structural part of a unit of property. If the property has deteriorated to a state of disrepair, such restoration should return the property to its ordinary efficient operating condition or should rebuild the property to a "like new" condition after the end of its class life. An "adaptation" modifies the property for a new or different use if the taxpayer's intended use of the property has changed from the time that it was originally placed in service. Understanding the temporary regulations will allow the proper identification of a taxpayer's capital expenditures, with consideration given to the particular facts and circumstances of each situation.

The temporary regulations contain specific examples of expenses related to various systems within a unit of property that are considered to be deductible, including the replacement of—

- 20% of a building's HVAC units (e.g., 2 out of 10),
- 15% of the property's plumbing fixtures (e.g., 3 out of 20), and
- 10% of the building's windows (e.g., 10 out of 100).

This raises an interesting question: can the examples above be extrapolated to the building system as a whole? That is, could there be a situation in which expenditures that did not exceed 20% of the HVAC's cost could be expensed?

Disposition of Components

In addition to defining the unit of property for tracking expenditures, the temporary regulations expanded the definition of dispositions to include the retirement or disposal of a building's structural components (e.g., roof, windows). Prior to January 1, 2012, losses were not allowed for retired building components, and thus the replacement of building components resulted in the continued depreciation of both the replaced and replacement property.

Under the temporary regulations, taxpayers can end the depreciation of building components upon removal and recognize a loss.

Under the temporary regulations, taxpayers can end the depreciation of building components upon removal and recognize a loss. A proper cost segregation study now includes costs by building system, as well as additional information to identify costs and qualitative information on building components. This will facilitate a taxpayer's accurate reporting of losses when the component is disposed.

In the case of existing property, a cost segregation study should take into consideration a taxpayer's fixed-asset accounting of the building's historical cost and should aid in the identification of disposals that will occur as a result of the new capital improvements. Consider a simplified example: a 25-year-old building is depreciating three roofs in its fixed-asset system—the original, which had been completely torn off, and two subsequent replacements. Under the regulations, only the cost of the most recent roof should be carried into the fixed-asset system. Thus, the engineering-based techniques used in cost segregation can readily identify and estimate such dispositions, in conjunction with the new capital improvements.

An Opportunity for Taxpayers

Regardless of size or scope, all taxpayers looking into construction projects should utilize engineering-based cost segregation studies, especially in light of the temporary regulations. Such projects include a new property built from the ground up, an extensive remodeling project of an existing building, a minor interior refresh, a tenant space fit-out, the acquisition of an existing property, or the lookback into an established fixed-asset system in order to identify assets that taxpayers can now write off. ❑

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