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I Know It When I See It – What is a Capital Expenditure?

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According to Wikipedia, the fount of all knowledge, the phrase "I know it when I see it" is a colloquial expression by which a speaker attempts to categorize an observable fact or event, although the category is subjective or lacks clearly defined parameters. This phrase was famously used in a U.S. Supreme Court decision to describe the threshold test for obscenity. (See *Jacobellis v. Ohio*, 378 U.S. 184 (1964)). Although this blog post will, unfortunately, likely not become as well known as the *Jacobellis* case, it will discuss, "What is a Capital Expenditure?" My guess is that a lot of tax-exempt bond advisors use intuition when determining that certain expenditures qualify as "capital expenditures" for tax-exempt bond purposes. In other words, they know a capital expenditure when they see one. However, the question as to what constitutes a "capital expenditure" under the tax-exempt bond rules may be difficult to answer at times.

Treas. Reg. Section 1.150-1(b) defines "capital expenditure" as:

> any cost of a type that is properly chargeable to capital account . . . under general Federal income tax principles. For example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures.

Without the example provided, I am not sure I would know what type of expenditure is "chargeable to capital account." Luckily, the example makes it clear that both the acquisition of a building and the construction of a building clearly qualify as capital expenditures. However, it becomes more difficult to determine whether an expenditure "improves" a building. For example, does a replacement of windows in a building "improve" a building or merely "maintain" the building under general Federal income tax principles? Does it matter if some of the old windows were cracked, or that the new windows are more energy efficient?

Fortunately, the IRS has some helpful guidance on this topic on its website: "Tangible Property Regulations – Frequently Asked Questions"[1]. According to this guidance, an improvement to property, which would be required (or in the tax-exempt bond world, allowed) to be capitalized, occurs if one of the three following conditions are met:

- The expenditure qualifies as a "betterment," which is (thankfully) further described to include

(i) amounts paid to fix a material defect that arose before acquisition or during construction of the property, (ii) amounts paid for a material addition to the property, such as a physical enlargement or material increase in capacity, or (iii) amounts paid to materially increase productivity, strength, quality or output of the property.

- The expenditure is used to “restore” the tangible property, which again is (thankfully) further described to include the following examples: (i) amounts paid to restore property after it has been damaged (e.g., by a hurricane); and (ii) amounts paid to restore property to its ordinary operating condition after it has deteriorated to a state of disrepair or after the end of its class life.

- The expenditure is used to “adapt” the tangible property to a new or different use (e.g., converting a manufacturing facility to a showroom).

Given the difficulty, at times, of distinguishing between an improvement and maintenance, the tangible property regulations provide a few safe harbors. One such safe harbor permits a taxpayer to elect to capitalize repair and maintenance costs if such costs are treated by the taxpayer as capital expenditures for financial accounting purposes.

So, when you are looking through that brand new, energy efficient window, do you see a capital expenditure?

FOOTNOTES

[1] This guidance is a summary of the various Internal Revenue Code (“IRC”) provisions and Treasury Regulations addressing current expenses (under Section 162 of the IRC), depreciation (under Sections 167 and 168 of the IRC), and capitalization (under Sections 263 and 263A of the IRC).

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