

# New Repair Regulations and the Impact on Owners of Investment Real Estate

On December 23, 2011, the IRS issued comprehensive guidance regarding amounts paid to acquire, produce or improve tangible property and what can be expensed as repairs and maintenance or materials and supplies. These regulations are commonly referred to as the “repair regs” and are extremely lengthy (approximately 250 pages) and complex. Though the IRS uses the terminology temporary, the regulations are current law and are effective January 1, 2012 or for taxable years that begin after 1/1/12. These regulations impact three IRS code sections:

1. §263(a)-Acquisitions and improvements
2. §162-Materials and supplies
3. §168-General accounts and MACRS dispositions.

On November 20, 2012, the IRS issued Rev. Proc. 2012-73 which delayed the mandatory implementation date of the repair regs to tax years beginning on or after January 1, 2014. Early implementation as of 1/1/12 is allowed, however the IRS has emphasized that three provisions of the regulations will likely change. These provisions are the de minimis expensing rule, dispositions and the routine maintenance safe harbor (this provision does not apply to buildings under the temporary regs).

Below is a summary of the temporary regulations with an emphasis on those areas most impacting investment real estate owners.

## Unit of Property

The temporary regulations (“regs”) redefined a unit of property as it relates to an improvement. A building is still a unit of property (“UoP”), as under prior regulations. However, the regs also define nine building systems that are now considered a UoP when determining if an expenditure is a capital expenditure or a repair. A major repair to not only the building itself but one of these systems or a structural component of the building (such as a roof) is considered an improvement and must be capitalized.

The nine buildings systems are:

1. HVAC systems
2. Plumbing systems
3. Electrical systems

4. Escalators
5. Elevators
6. Fire protection and alarm systems
7. Security systems
8. Gas distributions
9. Other systems and components identified in published guidance.

A UoP for a condominium or cooperative is the structural components with respect to the individual unit or the portion of the building that a taxpayer has possessory rights as compared to the building or building systems as a whole.

## Definition of an Improvement

Under the regs, there are three types of improvements.

- 1. Betterment – corrects a material defect that existed prior to acquisition. An example in the regs illustrates a betterment:**

### Facts

- In Year 1, X purchases a store located on a parcel of land that contained underground gasoline storage tanks left by prior occupants.
- The parcel of land is the unit of property.
- The tanks had leaked, causing soil contamination.
- X is not aware of the contamination at the time of purchase.
- In Year 2, X discovers the contamination and incurs costs to remediate the soil.

### Conclusion

- Remediation costs result in a betterment to the land because X incurred costs to ameliorate a material condition or defect that existed prior to X's acquisition of land.

The regs also differentiate between a building refresh and betterment. A refresh is a cosmetic change to a structural component and can be expensed as repairs. An example in the regs illustrates the difference between betterment and a refresh.

### Facts

- X owns a nationwide chain of retail stores and periodically refreshes the appearance and layout of its stores.
- X pays amounts to refresh 50 stores during the taxable year.
- The work consists of replacing and reconfiguring a small number of display tables and racks, corresponding lighting relocations and flooring repairs, moving a wall, patching holes in walls, repainting, repairing vinyl flooring and power washing the outside.
- The work does not ameliorate any material conditions or defects that existed when X acquired the store and does not result in any material additions to the store building.

### Conclusion

- The work performed keeps X's store buildings' structures and buildings' systems in the ordinary efficient operating condition that is necessary for X to continue to attract customers to its stores. Therefore, X is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments.

## 2. Restoration-restoring to operating or like new condition. If a loss is calculated on the disposal of the old component, the replacement must be capitalized and cannot be expensed as a repair. An example in the regs illustrates a restoration:

### Facts

- X owns a large retail store and discovers a leak in the roof.
- X hires a contractor to inspect and fix the roof.
- The contractor discovers that a major portion of the sheathing and rafters has rotted and recommends replacement of the entire roof
- X pays the contractor to replace the entire roof with a new roof.

### Conclusion

- The replacement of the roof is a major component or substantial structural part of the building structure.
- X must capitalize the amount paid to replace the roof as a restoration.

## 3. Adaption to new or different use- In general, an amount paid to adapt a unit of property to a new or different use if the adaption is not consistent with the taxpayer's intended ordinary use of the property at the time it was originally placed in service. The following is an example in the regs:

### Facts

- X is a manufacturer and owns a manufacturing building that has been used from Year 1 to Year 30 as a manufacturing building.
- In Year 30, X pays to convert the building into a showroom.
- None of the replacement materials are better than the original materials

### Conclusion

- The amounts paid were to convert the facility were not consistent with X's intended ordinary use of the building structure at the time it was placed in service.
- The amounts paid are improvements and must be capitalized.

## Leasehold Improvements

A UoP of a leased building depends on the portion that is leased as well as who is making the improvement (lessor vs. lessee). If the entire building is leased, the UoP is the building, building systems and structural components. If a portion of the building is leased, the UoP is the building system and structural components related to the portion of the building that is leased.

A lessor improvement is considered an improvement to the underlying property and is not treated as an acquisition or production of a new UoP. The lessor must capitalize amounts paid through a construction allowance and lessee improvements paid as a substitute as rent. Amounts capitalized by the lessor may not be capitalized by the lessee.

The lessee must capitalize improvements but the improvement standards are applied to the portion of the building and building systems subject to the lease. A leased space is a separate UoP. The amount initially capitalized as a lessee improvement is treated as a cost of acquiring or producing a UoP and is a UoP separate from the underlying leased property (as opposed to an improvement to the underlying property). Subsequently, if an improvement is made to the lessee improvement, this improvement is not a UoP separate from the lessee improvement, but is considered an improvement to this UoP.

The regs clarified that leasehold improvements must be depreciated based on IRS cost recovery provision methods and lives without regard to the lease term.

## Acquisition Costs

Most of the 2008 proposed regulations were retained under the regs. Pre-decision investigative costs related to real estate acquisition do not need to be capitalized unless they fall under the bright line test of being “inherently facilitative.” However, pre-decision investigatory costs related to personal property must be capitalized. If these costs are paid as a lump sum for both real and personal property, a reasonable method of allocation must be made to determine the costs that may be expensed.

Facilitative costs must be capitalized. These are costs paid in the process of investigating or pursuing the acquisition of property.

Some costs are considered inherently facilitative and must always be capitalized. These costs include the following:

- Transportation costs.
- Bidding costs, application fees.
- Appraisal costs.
- Architectural, engineering, inspection, environmental, etc. services.
- Expenses for preparing or reviewing property’s acquisition documents.
- Costs to negotiate the acquisition terms.
- Expenses for evaluating and examining a property’s title.
- Costs to obtain permits and regulatory approvals.
- Property conveyance costs.
- Finder’s fees and broker’s commissions.
- Qualified intermediary fees in a like-kind exchange.

Employee costs and overhead are not considered facilitative but an election can be made to capitalize these on a transaction by transaction basis.

If the property is ultimately not acquired or produced, the capitalized costs can be deducted when the acquisition is abandoned.

## Materials and Supplies

The regs define materials and supplies as tangible property used or consumed in the taxpayer's business that is not inventory and falls into any of the following categories.

- 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
- Fuels, lubricants, water, and similar items that are reasonable expected to be consumed in 12 months or less,
- It is a UoP with an economic life of 12 months or less
- It is a UoP with acquisition or production cost of \$100 or less
- Other property identified as materials and supplies in published IRS guidance.

The regs further differentiate between incidental and non-incidental supplies. Incidental supplies are carried on hand, there is no record of consumption and no inventory is taken. The cost of incidental supplies is deductible when the amounts are paid or incurred. Records of consumption and inventory are kept for non-incidental supplies. The cost of non-incidental supplies is deductible when these supplies are used or consumed.

Taxpayers with an applicable financial statement ("AFS") or a certified audited financial statement accompanied by an independent CPA's report used for credit or reporting purposes have a special de minimis expensing rule. These taxpayers can follow the book treatment if written accounting procedures are in place for expensing amounts paid under a certain dollar amount. There are overall limits of the total expense that can be deducted for tax purposes (the greater of .1% of gross receipts or 2% of total depreciation and amortization). For small taxpayers without any type of audited financial statement, any expenditure over \$100 must be capitalized. Some relief may be gained through §179 expensing or bonus depreciation.

Rotable and temporary spare parts are materials and supplies acquired for installation on a UoP, are removable, and either repaired or improved and reinstalled or stored for later installation. The regs allow three options for the tax treatment of these parts:

- Deduct costs upon disposition.
- Capitalize and depreciate.
- Elect an optional method which includes five parts to follow from initial installation, removal, repair or improvement of the part, reinstallation to disposal.

## Dispositions

A loss on disposition must be calculated and recognized on every building component removed from a building or building system. In addition, as mentioned previously, the restoration rules require that if a loss has been taken, the replacement must be capitalized –taxpayers cannot take both a loss on disposition and a repair deduction.

Casualty losses are treated the same as dispositions under the regs. Since the taxpayer recognized a loss, any repairs or replacements must be capitalized as these are made to restore the property.

The advantage of the new regs is that, unlike the prior regulations, the old basis is written off and a loss is recognized as opposed to continuing to depreciate the old property. The disadvantage is that a replacement must be capitalized, even if it would otherwise be considered a repair. If the taxpayer has capitalized the building as one unit and has not tracked the components of the building, recordkeeping can be burdensome. Taxpayers must use a reasonable method to determine the basis for the disposition and this method must be consistently applied to all dispositions.

Relief may be gained by electing GAA as discussed in the next section.

## General Asset Accounts

General asset accounts (“GAA”) give taxpayers greater flexibility in regards to the disposition of assets. Assets with the same MACRS recovery period, depreciation method, convention and year placed in service are placed in the GAA. Assets no longer have to be in same asset class as under prior regs. The regs now allow a taxpayer to terminate GAA treatment for a single asset. Thus, electing to group assets in a GAA allows the taxpayer to either claim a loss on disposition and capitalize the new restoration, or to continue depreciating the old asset and deduct the restoration as repairs & maintenance if applicable.

An example of the advantages of electing GAA treatment is as follows:

### Facts

- X purchased a building on 1/1/2008 for \$10 million
- A cost segregation study determined the cost allocated to the roof was \$150,000
- In 2012, the roof was repaired at a cost of \$200,000. This repair did not result in betterment or a restoration.
- Accumulated depreciation on the roof was \$15,000

### Conclusion

Late GAA election not made	Late GAA Election Made
Old roof disposed, loss of \$135,000 recognized.	Continue to depreciate the old roof.
New roof repairs of \$200,000 must be capitalized & depreciated over 39 years.	The \$200,000 repair is expensed.

Thus, electing GAA treatment (in this case a late election to be discussed in the next section) results in an additional tax deduction of \$65,000 in the year the roof was repaired.

## Revenue Procedures 2012-19 and 2012-20

Two revenue procedures (“Rev.Proc”) were issued in 2012 to provide guidance on how taxpayers can obtain automatic consent to comply with the new regulations. Rev.Proc 2012-19 provides guidance

on changes to repairs & maintenance, and materials & supplies while Rev. Proc 2012-20 addresses changes to depreciation and disposition.

Rev. Proc 2012-19 provides automatic change procedures for 13 different method changes.

1. Deducting repair and maintenance costs when erroneously capitalized.
2. Changing to a regulatory accounting method.
3. Deducting non-incidentals materials and supplies when used or consumed.
4. Deducting incidentals materials & supplies when paid or incurred
5. General method for non-incidentals rotatable and temporary spare parts.
6. Optional method for non-incidentals rotatable and temporary spare parts.
7. Deducting dealer expenses facilitating the sale of property.
8. Deducting de minimis amounts.
9. Deducting applicable costs for investigating or pursuing acquisition of real property.
10. Changing to safe harbor for routine maintenance (other than buildings)
11. Capitalizing costs to facilitate sale of property (nondealers)
12. Capitalizing and depreciating acquisition or production costs
13. Capitalizing and depreciating improvements to real property.

Rev Proc 2012-20 modifies Rev. Proc 2011-14 and adds six automatic changes.

1. Depreciation of leasehold improvements.
2. Changing from one permissible method of MACRS depreciation to another.
3. Disposition of building or structural component
4. Disposition of tangible depreciable assets other than a building or its structural components
5. Disposition of assets in a GAA
6. GAA elections

A change to conform to the temporary regs is a change in accounting method. Form 3115 must be prepared to file for an automatic method change. Most of the method changes listed above will require a catch-up adjustment which is referred to as a Section 481(a) adjustment. This adjustment captures the cumulative difference between the current and proposed methods of accounting.

Some of the methods require a modified cut-off or cut-off adjustment, such as deducting de minimus materials and supplies. These method changes will not have a catch-up adjustment. Instead, only items that arise on or after the beginning of the year will be accounted for under the new method.

## About Scarpello Consulting

Launched in 2001, Scarpello Consulting provides Cost Segregation consulting services to help clients maximize their depreciation allowances while minimizing audit risk. The firm has four locations including Los Angeles, CA, Omaha, NE, Overland Park, KS and New York City, NY. Additional information is available at [www.ScarpelloConsulting.com](http://www.ScarpelloConsulting.com).