

Final Repair Regulations and the Impact on Owners of Investment Real Estate

On September 13, 2013, the IRS released final regulations providing 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.” The regulations are effective September 19, 2013 and apply to taxable years that begin on or after January 1, 2014. Early implementation as of January 1, 2012 is allowed. These regulations impact two IRS code sections:

1. §263(a)-Acquisitions and improvements
2. §162-Materials and supplies

In September 2014, final regulations regarding dispositions of property under §168 were issued. These regulations apply to tax years beginning on or after 1/1/14; however taxpayers have the option of applying the previous temporary regs beginning on or after 1/1/12.

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

Unit of Property

The 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 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 in the property prior to the time of acquisition or arose during production of the property. A betterment is also a material addition to the property or is reasonably expected to materially increase the productivity, strength, quality or output of the UoP. 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.
- In Year 2, X discovers the contamination and incurs costs to remediate the soil.

Conclusion:

- Remediation costs are a betterment to the land because X incurred costs to correct a material condition that existed in the 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. The replacement must be a major component or substantial structural part of the building structure. A major component is a part or combination of parts that performs a discrete and critical function in the operation of the UOP. A substantial structural part is a part or combination of parts that comprises a large portion of the physical structure of the unit of property. The IRS regs clarify that an incidental component that performs a discrete and critical function, such as a switch, generally will not constitute a major component.**

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 final 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.
- Contingency fees facilitating the purchase of property.

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 \$200 or less
- Other property identified as materials and supplies in published IRS guidance.

The cost of materials and supplies is deductible when these supplies are used or consumed unless they are rotatable and temporary spare parts.

Rotatable 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.

Taxpayers may elect to capitalize rotatable and temporary spare parts. This election is not available for other materials and supplies.

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 if the amount paid does not exceed \$5,000 per invoice or per item as detailed on the invoice. For small taxpayers without any type of audited financial statement, any expenditure over \$500 per invoice or item must be capitalized. In order to utilize this safe harbor, accounting procedures must be in place at the beginning of the year to deduct amounts paid under this specified level. This safe harbor is elected annually by including a statement with the taxpayer’s timely filed return.

Additional relief may be gained through §179 expensing or bonus depreciation.

Safe Harbor for Small Taxpayers

Taxpayers with gross receipts of \$10 million or less are qualifying small taxpayers. Qualifying small taxpayers may elect to not apply the improvement rules if the total amounts paid for repairs, improvements, etc. do not exceed the lesser of \$10,000 or 2 percent of the adjusted basis of the building. The building unit of property must have an unadjusted basis of \$1,000,000 or less to be eligible for the safe harbor.

The safe harbor is elected annually on a building by building basis by including a statement with the taxpayer's tax return for the year the costs are incurred.

Routine Maintenance Safe Harbor

Maintenance expected to be performed on buildings more than once in a ten year period is considered routine and not subject to capitalization. Amounts paid that fall under the definition of an improvement would not qualify. In addition, amounts paid for repairs, maintenance or improvement of network assets is not considered routine maintenance.

General Asset Accounts

Assets with the same MACRS recovery period, depreciation method, convention and year placed in service are placed in the general asset account ("GAA"). Assets no longer have to be in same asset class as under prior regs. The final regulations made making a GAA election unnecessary since taxpayers not electing GAA treatment will be allowed the same flexibility as those making this election as discussed below.

Dispositions

Unlike the temporary regulations, for disposition purposes the final regulations provide that a building includes its structural components. This rule allows taxpayers to forgo a loss upon the disposition of a structural component and expense the related repairs without having to elect GAA treatment. Partial dispositions are not allowed in a GAA;

therefore it would disadvantageous to elect GAA treatment if the taxpayer desires to write off these partial dispositions.

If the taxpayer desires to take a loss on a disposed component not in a GAA, then a partial disposition election must be made. This election is made on a taxpayer's timely filed return.

Revenue Procedures 2014-16 and 2014-54

Two revenue procedures ("Rev.Proc") were issued in 2014 to provide guidance on how taxpayers can obtain automatic consent to comply with the final regulations. Rev.Proc 2014-16 modifies Rev. Proc. 2011-14 and supersedes Rev. Proc 2012-19 and provides automatic method change procedures to repairs & maintenance and materials & supplies. Rev. Proc. 2014-54 modifies Rev. Proc. 2011-14 which was previously modified by Rev. Proc. 2014-17 and provides automatic accounting method changes relating to general asset accounts, property depreciated as MACRS property and dispositions.

Rev. Proc 2014-16 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 incidental 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.

The final regs state that the de minimis safe harbor election is a change in procedure and by itself not a change in accounting method. For example, if a taxpayer changes its policy to reflect the increased expensing limits of \$500, the taxpayer is not required to file for a change in accounting method.

Rev Proc 2014-54 addresses several automatic changes including the following:

1. Depreciation of leasehold improvements.
2. Changing from one permissible method of MACRS depreciation to another.
3. Disposition of a 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, including late elections and revocations.
7. Late partial disposition elections

A change to conform to the final regs is a change in accounting method. Form 3115 must be prepared to file for an automatic method change. Some 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.

Other changes may require a modified cut-off or cut-off adjustment, such as deducting de minimis 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.