Real Estate Industry Concerns with New Repair Regulations from IRS

There are many superstitions surrounding Friday the 13th. Most believe it to be a “bad luck” day and one should be very careful during one. However, a few feel that it is a good luck sign. Superstitions develop through legend and facts from the past.

Perhaps the IRS and the Treasury Department by design used Friday the 13th in September to release the final regulations that affect the treatment of materials and supplies, capitalization of amounts paid to acquire or produce tangible property and the capitalization and deduction of expenditures relating to repair or improvement of tangible property. The IRS also released proposed regulations for Partial Dispositions and General Asset Accounts (GAA).

These regulations will impact most taxpayers, regardless of industry. The regulations are over 100 pages and include dozens of examples. This article focuses on several key components of the regulations that will affect the real estate industry and all taxpayers who own business real estate.

The regulations do not go into effect until tax years starting on or after January 1, 2014. However, certain decisions based on the regulations need to be considered in December 2013 to prepare the taxpayer. The regulations also allow for early adoption for the 2012 and 2013 tax years.

UNIT OF PROPERTY (UOP)

To best apply the regulations for real estate, one should start with the understanding of the term “unit of property” (or UOP).

In the past, many decisions to deduct or capitalize improvements to a building were made by comparing the expenditure to the entire building; the entire building was the UOP. The regulations now segregate a building into nine systems as follows:

- Security systems
- Fire protection
- Escalators
- HVAC
- Elevators
- Electrical
- Plumbing
- Gas Distribution
- Structural components (roof, walls, floors, ceilings and foundation)

Now under the final regulations, when an expenditure for a repair occurs, the taxpayer must compare the extent of the improvement as it relates to one of these nine systems.
For example, an owner has an office building that contains an HVAC system that incorporates 10 roof-mounted units. After many years, two units must be replaced. Per an example in the IRS guidance, replacement of the two roof-mounted units is not a material addition to or a material increase in the capacity of the HVAC system (the effective new UOP or one of the nine systems). In this case, the owner is not required to capitalize the amounts paid for these replacements as betterments to the building unit of property. However, replacing seven or eight of the 10 HVAC units would likely be betterment, and a capital event – as compared to the HVAC system. Under prior tax authority, replacing seven or eight HVAC units may have been a repair, as compared to the larger building UOP.

**IMPROVEMENT STANDARDS (BAR)**

The regulations also define improvement standards. The question of whether an expenditure is an improvement or repair is not always easy to discern. There are many examples in the regulations for “repairs vs. capital,” but there are few “bright line” tests providing specific percentages or thresholds to make these decisions. Capitalization will be dependent on facts and circumstances.

Remember we are comparing to one of the nine units of properties mentioned earlier, or “building systems.” Improvements to property must be compared to the BAR.

- Betterment – the correction of a material defect present in the unit of property, a physical enlargement or increase in productivity, strength, quality or output.
- Adaptation - changes the property to a new or different use or to a use not consistent with the owner’s ordinary use of the UOP at the time originally placed in service by the owner;
- Restoration - to restore a UOP to its ordinary operating condition after disrepair; rebuilding of UOP to a like-new condition after the end of its class life; replacement of a major component or substantial structural part of a UOP.

Expenditures that are a betterment, adaptation, or restoration to a UOP (or one of the nine building systems) must be capitalized.

**SAFE HARBORS**

How does an owner of real estate work with these regulations?

The regulations provide the owners of real estate a “de minimis” policy to help administer these repair/capitalization regulations based on whether or not the taxpayer has an applicable financial statement.

**Taxpayers who have “applicable financial statements” may deduct up to $5,000 of the cost of an item of property per invoice** (or per item as substantiated by an invoice). To take advantage of the $5,000 de minimis rule, the taxpayer must have a written policy at the beginning of the tax year. This is an annual election. Taxpayers must follow the same policy for income tax and financial reporting.

Applicable financial statements (AFS) are (1) financial statements required to be filed with the SEC (2) a certified audited financial statement accompanied by the report of an independent CPA; and (3) financial statements, other
than a tax return, required to be provided to the federal or state government or any federal or state agency besides the SEC or IRS. It does not include reviewed or compiled financial statements unless they meet the requirements of item (3) above.

In a concession to businesses without an AFS, the final regulations have a safe harbor for those taxpayers but at a lower amount. The per item, or invoice, amount is $500.

**CAPITALIZE EVERYTHING**

What if you do not want to worry about how to expense vs. capitalize expenditures? The regulations provide that you could elect to capitalize everything for income tax purposes, if the same costs are capitalized on your financial books and records.

**SMALL BUILDING EXCEPTION**

One more way the regulations will help taxpayers with smaller buildings is with an annual safe harbor election for buildings owned or leased with an unadjusted basis (generally the cost) no greater than $1 million. The owner must have average gross receipts of $10 million or less during the preceding three years.

Under this small building exception, the owner is not required to capitalize improvements if the total amount paid for repairs does not exceed the lesser of $10,000 or two percent of the unadjusted basis of the building. This is applied to each building owned.

**ROUTINE MAINTENANCE**

A “routine maintenance” safe harbor was also outlined in the regulations. If an owner can answer yes to these five questions the maintenance item can be expensed.

1. Were the costs incurred for routine maintenance on a UOP?
2. Were the activities performed as a result of the owner’s use of the property?
3. Were the costs to keep the UOP in ordinary operating condition?
4. Did the work include cost activities such as cleaning, inspecting, testing and replacement of components with comparable parts?
5. Did the owner expect to incur these costs more than once during the asset class life or if a building, more than once during a 10 year period at the time the asset was placed in service?

**ACQUISITION OF PROPERTY**

The regulations state that certain costs for acquiring real property need to be capitalized. This is not breaking news. The regulations do lay out examples of acquisition costs (facilitative amounts) that should be capitalized, such as appraisals, negotiating the terms or structure of acquisition, tax advice, application fees and bidding costs, preparing and reviewing documents that effectuate the acquisition, title work, obtaining regulatory approval and permits,
conveying property between parties, finders’ fees or brokers’ commissions, architectural, geological, survey, engineering or inspection services and the cost of a qualified or other facilitator of a deferred tax exchange.

Conversely, if the property was not acquired, these costs would be expensed at that time.

**DISPOSITION OF PROPERTY**

IRS guidelines for “partial disposition” of property remain in the form of proposed regulations. Final regulations are expected to be announced before January 1, 2014. These proposed regulations may be relied upon for tax years 2012 and 2013, if a taxpayer chooses to early adopt the new rules.

A disposition occurs when an asset is sold, exchanged, physically abandoned, destroyed (including casualty), transferred to supplies, scrapped, or involuntarily converted. Under the most recent Proposed Regulations (for Partial Dispositions and GAA), owners may “elect” to treat a partial disposition of an asset as a disposition. An owner may claim a loss upon the disposition of a structural component (or a portion thereof) of a building without identifying the component as an asset before the disposition event.

The election is made on a timely filed return including extensions in the taxable year in which the disposition occurs. In cases of a casualty event, like kind exchange, sale of a portion of an asset, or involuntary conversion, the partial disposition rule is mandatory.

Under the GAA election, normally no loss on disposition is recognized until all assets in the GAA have been disposed. Under the 2013 Proposed Regulations, unless it qualifies either as a partial disposition or qualifying disposition this continues to hold true. Guidance in these Proposed Regulations (for Partial Dispositions and GAA) is significantly different than the IRS rules in the 2011 Temporary Regulations. The owner should consult his/her tax advisor concerning the general asset account (GAA) election.

For example, assume that a taxpayer has elected GAA and it is determined based on the repair regulations that work to a roof needs to be capitalized. The taxpayer would be precluded from expensing the remaining costs of the old roof. In essence, he would be depreciating two roofs. Without the GAA election the taxpayer could (under a reasonable method) expense the remaining basis of the original roof using the “partial disposition” election in the most recent proposed regulations.

**CONCLUSION**

Real estate owners have a few considerations to ponder:

- For those with applicable financial statements—a written policy to expense individual items $5,000 or less needs to be written and in place before the first day of the first tax year beginning on or after January 1, 2014;
- For those without applicable financial statements—a policy to expense individual items $500 or less needs to be understood before the first day of the first tax year beginning on or after January 1, 2014, although a written policy is preferable;
A review of repairs and capitalized expenditures for 2012 and 2013 need to be completed to determine if early adoption of the regulations are advantageous;

Buyers of smaller buildings need to consider a depreciation study to see if it is practical to allocate $1,000,000 or less to the building to utilize the small building exception;

Owners of buildings should review tenant improvements “on their books” for structural changes (moving walls, change of ceilings) that may qualify for expensing; and

Tenants should review improvements “on their books” to determine compliance with new regulations.

As you can see the new regulations have given real estate owners and tax practitioners a few options. This article highlights important rules in the final regulations as related to real estate owners. It does not attempt to review all provisions. A grasp of all provisions is critical to full compliance.

It is to be determined if the regulations that were sent out on that Friday the 13th are good or bad luck. Only time will tell.

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