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New regs are more concrete when it comes to repairs

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After years of controversy over subjective and "facts and circumstances" determinations as to if repairs should be capitalized or deducted, the IRS recently released much anticipated final repair versus capitalization regulations. The new regulations will give taxpayers something more concrete in determining if repairs should be capitalized or deducted. These regulations are far reaching and will affect every taxpayer that holds tangible property. Taxpayers need to pay attention now as these new rules are applicable for tax years beginning on or after January 1, 2014.

These final regulations have been long anticipated by taxpayers and tax professionals to reduce controversy over what was deductible as a repair and what had to be capitalized. In the past, taxpayers relied on liberal regulations and court cases to determine whether a repair was deducted or capitalized. The IRS also released proposed and temporary regulations a number of times in the past in an attempt to clarify this issue but failed. Most recently, temporary regulations were released in 2011 that came as a big surprise to the real estate industry. These final regulations most closely resemble the 2011 temporary regulations. However, the IRS heeded taxpayer advice and included a number of taxpayer friendly changes.

The final regulations clarified and simplified a number of provisions of the preceding temporary regulations. They also created a number of safe harbors and taxpayer friendly elections. Some of the major highlights and changes of the final regulations are as follows:

* A routine maintenance safe harbor for buildings now allows taxpayers to deduct repairs that may have otherwise been capitalized if they can reasonably expect to perform the repair activity more than once in a 10 year period.

* Taxpayers may now elect to capitalize repair and maintenance items that are capitalized for financial statement purposes. This is an annual election to capitalize and depreciate the costs. It applies to all amounts paid for repairs during the tax year. This election reduces the administrative burden of tracking differences between financial statement accounting and tax accounting.

* A de minimis safe harbor was added to allow for the deductibility of items under certain dollar thresholds depending on whether the taxpayer has applicable financials statements or not. If taxpayers have an applicable financial statement they may deduct up to $5,000 per item. If a taxpayer does not have financial statements, the amount is limited to $500. A specific capitalization policy must be in effect for the tax year.

* The definition of an improvement has been redefined and clarified. Improvements to property must be capitalized if they constitute a betterment, a restoration or an adaption of that property. The improvement rules must be applied separately now to buildings, their building structure and certain major building systems as defined in the regulations.

* Removal costs related to property are not capitalized as an improvement if the taxpayer realizes a gain or loss on disposition. If no gain or loss is realized, the taxpayer deducts the removal costs if

they directly benefit the unit of property. Otherwise, the removal costs are considered an improvement.

* A small taxpayer safe harbor provides relief to taxpayers if their original building cost was under $1,000,000 and their average annual gross receipts are under $10,000,000. A small taxpayer does not need to capitalize improvements if total annual costs are less than the smaller of $10,000 or 2% of the original building cost

* The definition of the betterment test has also been redefined. There are three tests to determine if a cost is a betterment and thus an improvement. A cost is for a betterment if it:

 * Ameliorates a material condition or defect

 * Is for a material addition or a material increase in the capacity or space of the property

 * Is reasonable expected to materially increase the productivity, efficiency, strength, quality or output of the property

The implementation of these final regulations needs to be started now due to the January 1, 2014 effective date. Additionally, taxpayers may elect to adopt the regulations as early as tax years beginning on or after January 1, 2012. Due to this quick timing, taxpayers should be consulting with their tax advisors now to ensure there are no missed opportunities.

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