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Repair or improvement: The difference can save you thousands of dollars on your taxes

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Repairs versus improvement

One of the most overlooked deductions relative to owning commercial real estate is the difference between an improvement and a repair. They may appear to be similar but how you present and structure the facts can be the difference between a \$20,000 immediate deduction or a \$500 deduction every year for 39 years. This is because improvements need to be considered part of the cost basis of the property and depreciated over the useful life of the property (27.5 years for residential, 39 years for commercial). Based on the time value of money, the larger immediate deduction is much more valuable to the building owner. The way it is planned out and structured can mean the difference in winning or losing an IRS audit.

Repairs versus improvements is even a tough question for the IRS. In their internal manual, it states "it is a difficult issue requiring maximum use of judgment".

8 Powerful Tax Strategies

So, here are eight powerful strategies to help you ensure your repairs will be immediately deductible:

1. Segregate your repairs from improvements— If you have a contractor making a major improvement to your property, do not ask him to fix a bunch of minor stuff along the way. By including everything in one bill, all the work becomes an improvement. Hire a separate contractor to do all of the small stuff and get a separate bill.
2. Fix a minor portion only—if you replace an entire floor, it is an improvement. If you only the small portion that is broken, it is a repair.
3. Use comparably priced materials—using comparable materials makes it a repair. Using better material makes it an improvement.
4. Fix damaged areas only—replacing something that is worn out or broken is a repair. Replacing something that is not worn out or broken is an improvement.
5. Repair after an event—a great time to fix everything up and have it considered a repair is after an event such as a broken pipe or weather related damage.
6. Repair during occupancy or between tenants—IRS agents are trained to watch out for owners who buy a property, renovate it, rent it and then try to take the repairs deductions. You want to do your repairs either while the tenant is in the space or between tenants to avoid having to treat the cost as improvements.

7. Classify the fix-up on your books as a repair—many building owners will put the cost of repairs on their books as an improvement and still try to deduct the cost as repairs on their tax return. The IRS places great importance on where you originally classify the cost on your books.

8. If possible, try to replace less than half of any wall, ceiling or floor—entire replacements are usually considered an improvement. If you do a partial replacement, you have a better chance of taking the repair deduction.

The bottom line is how you make and document the repairs makes all the difference in getting and keeping the deduction. Make sure you have kept good records including taking date stamped photographs, logging tenant repair calls, and getting separate bills from contractors for repairs.

Remember, it is better to take the immediate deduction of the entire cost than it is to depreciate the cost and using the principles of the time value of money will help you get the maximum tax breaks you deserve.

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