Real Estate Tax Alert

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The impact of the repair regulations on the real estate industry

Executive summary

The IRS recently published Notice 2012-73, which announced an intent to delay the effective date of the "repair regulations" that provide new rules related to the acquisition, production, or improvement of tangible property until taxable years beginning on or after January 1, 2014. On December 17, 2012, the IRS formally amended the effective date of repair regulations through the issuance of temporary regulations moving the applicability date. In light of the modified effective date, taxpayers in the real estate industry will have additional time to evaluate the impact of these regulations.

Notwithstanding the modifications to the effective date of the repair regulations, taxpayers in the real estate industry should begin to assess the impact of these rules in the near term, as there are both technical and practical issues that must be considered. In particular, consideration should be given to the impact of changes to the de minimis rule, the definition of a unit of property, and the rules governing the disposition of tangible assets, all of which are described in detail below. The effect of the regulations may vary based on business structure and investment strategy, as well the taxpayer's current policies related to repair expenditures. For example, a real estate investment trusts (REIT) with specific policies addressing the appropriate treatment of costs incurred to repair or maintain tangible property for financial statement purposes that has followed this approach for federal income tax purposes will need to consider the extent to which the repair regulations described below will give rise to a different tax result once implemented, as this will have a direct impact on taxable income available for distribution. On the other hand, a real estate fund that is audited on a fair value basis may not have a specific accounting policy to address the treatment of costs incurred to repair or maintain tangible property, and as a result, may have more practical issues to address. Specifically, consideration must be given to how these types of expenditures could be easily identified so that the federal income tax treatment of these costs can be appropriately analyzed. Another example may be a joint venture that prepares financial statements on a tax basis. In this situation, the materiality of the changes required by the repair regulations should be evaluated in light of the impact these changes will have on the financial statements.

As real estate businesses begin to evaluate the impact of the temporary regulations, many will likely discover that they need to change their methods of accounting associated with repairs and maintenance to conform to the new rules. In light of the focus that the IRS has on this issue, it is important for real estate businesses to develop an approach for implementation of these new rules to mitigate potential questions from the IRS upon examination.

Real estate assets

The repair regulations apply to all tangible property and include a number of important changes with respect to real property. While all taxpayers must take action to comply with the new rules, the impact of the regulations on businesses in the real estate industry may differ based on business structure and investment strategy. For example, REITs typically hold properties as long-term investments. These entities may benefit from tax planning under the new rules that can affect the timing and value of their deductions.

For other businesses, whose average holding period for real estate investments is shorter, compliance with the new rules may be of greater concern than other tax planning because the acceleration of deductions may be less valuable. Businesses with shorter term investment strategies may include funds that directly invest in real estate and joint ventures. Tax-exempt investors, a significant investor group in many real estate funds and joint ventures, may not derive as much benefit from tax planning related to the value of deductions.

What the repair regulations mean for real estate companies

The temporary regulations published in December 2011 create new rules related to the acquisition, production, or improvement of tangible property. These rules are meant to help taxpayers better distinguish between currently deductible repair and maintenance expenses under Section 162(a) and expenditures that must be capitalized under Section 263(a). The new repair regulations are significantly different in many respects from prior law, as well as from the 2006 and 2008 proposed versions of these regulations.

As noted above, the IRS has postponed the effective date of the temporary regulations until taxable years beginning on or after January 1, 2014. Although the effective date has been modified, the IRS will allow taxpayers to change their methods of accounting to comply with these new regulations for taxable years beginning on or after January 1, 2012. The IRS expects to issue final regulations in 2013, which would be effective for taxable years beginning on or after January 1, 2014.

Some of the potential impacts of the regulations important to the real estate industry are outlined below.

Costs to acquire property

Under the temporary regulations, taxpayers generally must capitalize the cost of acquiring real property. Amounts paid that must be capitalized include costs paid to defend or perfect title of the property, transaction costs, and costs for work performed prior to the date the unit of property (UOP) is placed in service. Activities performed by a taxpayer to determine whether to acquire real property, and which real property to acquire, are not required to be capitalized unless the cost is considered an inherently facilitative cost. Therefore, such pre-decisional investigative or pursuit costs for real property generally are not required to be capitalized.

The temporary regulations provide a new reasonable allocation rule for taxpayers that acquire real and personal property as part of a single transaction. The allocation will allow taxpayers to deduct pre-decisional investigatory costs related to the acquisition of real property while requiring such costs related to the acquisition of personal property to be capitalized.

Amounts paid to improve or maintain property

Improvements to tangible property generally must be capitalized under the temporary regulations. A UOP has been improved after it has been placed in service if the activity performed on the property results in a betterment to the UOP, restores the UOP, or adapts the UOP to a new or different use.

Although a building and its structural components generally are treated as a single UOP, the regulations require that the improvement standards be applied separately to the primary components of a building (whether owned or leased), meaning the building structure (e.g., floors or walls) or any of the specifically defined building systems. The building systems are broken out into nine components: ventilation, and air conditioning (HVAC) systems; plumbing systems; electrical systems; escalators; elevators; fire protection and alarm systems; security systems; gas distribution systems; and other structural components as defined in published guidance. Accordingly, a cost is treated as a capital expenditure if it results in an improvement to the building structure or to any of the specifically enumerated building systems.

While the regulations clarified the UOP rules related to buildings and their structural components by specifically enumerating applicable building systems, they did not clarify the improvement standards by creating an exception, safe harbor, or bright-line test associated with minor and recurring refresh or remodel costs. Instead, the analysis of whether refresh or remodel costs result in an improvement continues to be focused on the specific facts and circumstances. Accordingly, the new regulations merely provide detailed examples that result in a wide range of outcomes, based on the nature and extent of the work performed on the building and its structural components. While some of these examples are helpful and provide insight into the rationale for the conclusions reached, others seem to draw conclusions without providing much explanation.

Due to the subjective nature of the improvement standards, taxpayers may continue to experience uncertainty in the application of the law to situations involving refresh or remodel costs, and potential controversy upon audit. This may require taxpayers to spend more time documenting their related tax return positions, as well as their financial statement reserves for uncertain tax positions.

De minimis capitalization rule

The de minimis capitalization threshold in the new repair regulations generally allows costs incurred to acquire property (including materials and supplies) to be deducted for federal income tax return purposes to the extent expensed for financial statement purposes, unless a pre-defined ceiling is reached (i.e., the greater of 0.1 percent of a company's gross receipts for federal income tax return purposes or 2 percent of a company's depreciation and amortization for financial statement purposes). If the amounts to be deducted for federal income tax purposes exceed the ceiling, then the taxpayer could make an election to capitalize the excess over the ceiling as tax-only depreciable assets and continue to deduct the amounts up to the ceiling. However, the preamble to the temporary regulations indicates that this de minimis rule was not intended to disturb current agreements with IRS exam teams, such that the taxpayer could continue to deduct any amounts in excess of the ceiling if the IRS agrees that amounts deducted in excess of the ceiling do not distort the taxpayer's income.

Based on this new rule, taxpayers will need to consider how assets capitalized for federal income tax return purposes will be tracked to the extent they are not capitalized for financial statement purposes. This could mean a change to internal processes, controls, and related systems.

Dispositions of real property

A disposition of an asset includes the sale, exchange, retirement, physical abandonment, destruction, and transfer to a supplies, scrap, or similar account. The temporary regulations provide that the definition of a disposition for MACRS property is expanded to include the retirement of a structural component of a building and recognition of a loss.

Prior regulations disallowed partial retirements of a building because buildings were treated as a single UOP. Even though a subsequent capital improvement was made, the taxpayer was required to continue depreciating the remaining basis of the replaced component. Under the new repair regulations, however, a partial retirement is allowed. Therefore, taxpayers now can claim a retirement loss on the disposition of a building component or system. For example, capital improvements made to the lighting and electrical system of a commercial building may result in a retirement loss for any previously capitalized lights and wiring replaced during a remodel. Unfortunately, most taxpayers do not currently identify the newly defined building systems from the costs of a building. Taxpayers now will need to evaluate and determine the adjusted tax basis of retired components and building systems in order to claim a retirement loss.

In determining the appropriate asset disposed of, the repair regulations provide that the facts and circumstances of each disposition are taken into account. In general, the asset for disposition purposes cannot be larger than the UOP. However, each disposed-of building is the asset except if more than one building is treated as the asset under Reg. § 1.1250-1(a)(2)(ii). Additionally, consistent with the expansion of the definition of a disposition to include a retirement of a structural component of a building, the repair regulations provide that each structural component of a building is the asset for disposition purposes. Further, if the taxpayer properly includes an item in one of the asset classes 0.11 through 00.4 of Rev. Proc. 87-56 or classifies an item in one of the categories under §168(e)(3), then each item is the asset, provided it is not larger than the UOP. The repair regulations provide that a taxpayer generally may use any reasonable, consistent method to treat each of an asset's components as the asset for disposition purposes. The temporary regulations also provide specific rules for determining the placed-in-service year of the asset disposed of. Generally, the taxpayer must use the specific identification method to identify the asset disposed of.

The regulations make a variety of changes to the existing rules under Section 168(i)(4) regarding dispositions of assets from general asset accounts. Consistent with the expansion of the definition of disposition of MACRS property, the temporary regulations expand the definition of disposition under Reg. §1.168(i)-1(e)(1) to include a retirement of a structural component of a building. The existing rules for general asset accounts allow a taxpayer to elect to terminate general asset account treatment for an asset in a general asset account when the taxpayer disposes of the asset in a "qualifying disposition"; the repair regulations expand the definition of qualifying disposition to include most dispositions.

The repair regulations retain the existing rule that a taxpayer may use any reasonable method that is consistently applied to all of its general asset accounts for determining the unadjusted depreciable basis of an asset for which general asset account treatment is terminated. Consistent with the repair regulations for dispositions from multiple asset account, the regulations provide that the following methods are reasonable for identifying the placed-in-service year of the asset disposed of from the general asset account: specific identification; first-in, first out (FIFO); a modified FIFO method; a mortality dispersion table if the asset disposed of is a mass asset grouped in a general asset account with other mass assets; or any method designated by the Secretary. The last-in, first-out (LIFO) method specifically is not permitted.

Why does your business need to address the repairs regulations now?

Accounting method changes

Many real estate industry taxpayers will need to change their methods of accounting associated with the repair and maintenance of tangible property to conform to the new rules. The IRS has published guidance on accounting method changes to comply with the temporary regulations. Rev. Proc. 2012-19 provides rules for taxpayers making accounting method changes related to deduction and capitalization of expenditures under the temporary regulations, and Rev. Proc. 2012-20 addresses changes related to depreciation and dispositions. Except in certain circumstances, the revenue procedures require a full Section 481(a) adjustment. The revenue procedures also provide audit protection for those taxpayers that voluntarily change from an improper method of accounting to a permitted method of accounting, and they specifically allow for the use of statistical sampling.

The revenue procedures waive the "scope" limitations that are contained in section 4.02 of Rev. Proc. 2011-14 for the first or second tax year beginning after December 31, 2011. Therefore, a taxpayer filing during this period has the ability to file any of the new automatic accounting method changes under the automatic consent procedures.

IRS examinations

The IRS' Large Business &International Division issued a directive to field examiners in connection with examinations of the repair versus capitalization issue. For tax years beginning before January 1, 2012, the directive instructs field examiners to discontinue current examination activity with regard to the issues covered by the directive, and not begin any new exam activity with regard to those issues. However, the directive adds that if a taxpayer files a Form 3115 with regard to those issues on or after December 23, 2011, for a tax year not covered by the repair regulations, then field examiners should perform a risk assessment regarding the issues.

For tax years beginning on or after January 1, 2012, but before January 1, 2014, the directive instructs field examiners to determine whether the taxpayer has filed a Form 3115 in accordance with the applicable guidance. If the taxpayer has filed a Form 3115, then the examiner should perform a risk assessment regarding the method change. If the taxpayer has not filed a Form 3115, and the taxpayer is still in its first or second tax year beginning after December 31, 2011, then the examiner should not examine the issues and allow the taxpayer until the end of that period to file a Form 3115. If the taxpayer has not filed a Form 3115 by the end of that period, then the examiner should perform a risk assessment regarding the issues. For tax years beginning on or after January 1, 2014, the directive notes that field examiners should follow normal examination procedures. It is unclear whether the directive will be modified in light of the revisions to the effective date of the repair regulations as described in Notice 2012-73 and the recently issued temporary regulations.

Action items and benefits for real estate taxpayers

There are a number of items that real estate companies should consider in analyzing the impact of the new regulations on their businesses. Some of these items are outlined below.

Review current capitalization policies and prior year repairs studies

Complying with the new repair regulations likely will require most taxpayers to change their methods of accounting.

Except in limited circumstances, the regulations require a full Section 481(a) adjustment, which means taxpayers are going to need to review their current capitalization policies and any prior year repairs studies in order to conform to the new rules. Based on the new rules, some taxpayers may find that they have over-capitalized their repair expenditures, while others (especially those that previously undertook a repairs study) may find that they have over-deducted them. In either case, taxpayers should consider filing a Form 3115. By doing so, taxpayers that have over-capitalized their repair expenditures will receive an additional benefit through a one-year cumulative catch-up adjustment. On the other hand, those that have over-deducted their repair expenditures will receive audit protection, but at the cost of recapturing disallowed deductions over a four-year period. Taxpayers that have over-deducted their repair expenditures, and are required to recapture disallowed deductions over a four-year period, should be especially vigilant about understanding the impact this might have on cash flow assumptions and estimated tax payment obligations, as well as financial statement reserves for uncertain tax positions. The impact on tax returns also should be considered.

Evaluate the need for systems enhancements

The rules contained in the new repair regulations will require many taxpayers to evaluate the adequacy of certain systems and software programs. For example, the new UOP and de minimis rules will require taxpayers to consider how assets that may have to be capitalized for federal income tax return purposes will be tracked to the extent they are not capitalized for financial statement purposes. Most importantly for real estate industry taxpayers, the new disposition rules that impact building assets will likely make it more difficult to track adjusted tax basis associated with partial dispositions.

Cost segregation of real property

The disposition rules requiring the recognition of gain or loss in connection with partial dispositions of structural components necessitate that taxpayers track the costs of the enumerated building systems. Real estate companies should consider having future cost segregation studies analyze the costs of these building systems to take advantage of future dispositions.

Submit comment letters

The new repair regulations were issued in both temporary and proposed form. Accordingly, members of the real estate industry should consider requesting clarification by submitting comment letters focused on areas of law that lack clearly defined rules and safe harbors. One area of concern is the treatment of refresh, remodel, and moving costs.

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