PUBLICATION

New IRS Regulations On Repair Expenditures Impact Hospitality Industry

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The Internal Revenue Service (IRS) recently released long-awaited regulations governing the tax treatment of expenditures incurred to repair tangible property. These new regulations attempt to clarify and expand upon the current regulations that exist under Sections 263(a) and 162(a) of the Internal Revenue Code, and also attempt to address issues associated with tangible property subject to Code Section 168.

Taxpayers must comply with the new regulations, even though they are in temporary and proposed form. They do have the potential to affect any taxpayer that owns, improves or repairs tangible property. The new regulations could impact owner/operators in the hospitality industry who may have previously deducted certain costs associated with their commercial real estate. As the economy continues to improve, and hotels and restaurants begin undertaking previously deferred upgrades and repairs, owner/operators should be aware of these new regulations to understand their impact on tax accounting for these costs.

Background

The new regulations have been an ongoing project within the Treasury Department for nearly a decade. The distinction between currently deductible expenses and expenditures that must be capitalized has generally been an analysis driven by the facts and circumstances of a taxpayer's particular situation. A taxpayer can generally deduct the full cost of a repair in the year that the expense is incurred; however, improvements constituting more than just repair generally must be capitalized over a fixed life of the repaired asset. Thus, the distinction over what constitutes a repair as compared to an improvement, as well as what piece of property was improved, led to much confusion and litigation. The IRS endeavored to simplify the process by releasing several hundred pages of proposed regulations in 2006, which were later withdrawn, as well as another set released in 2008.

The just-released new regulations retain many of the provisions of the 2008 draft, which incorporated much of the already existing authority that had been promulgated under the relevant Code sections; however, there are some significant changes in the new regulations as well.

Some Significant Changes

One significant change in the new regulations is the application of the improvement or repair standards to buildings. The expenditure in question for a building must be looked at for its effect on major components or systems of the building as opposed to the building as a whole. Thus, the taxpayer must determine whether a repair or improvement was made to the elevator system, the HVAC system or the plumbing system instead of determining whether a repair or improvement was made to the building generally. The specific building systems listed in the new regulations are HVAC, plumbing, electrical, escalators, elevators, fire protection and alarm, security, gas distribution and any other system identified in published guidance.

The new regulations also now allow taxpayers the ability to take a retirement loss for major building components such as those discussed above. Although the cost of a new component will have to be capitalized, the fiscal blow is somewhat softened by the fact that, under the new regulations, the taxpayer may take a loss equal to the amount of basis allocated to the retired property that is being replaced.

What the New Regulations Mean for Taxpayers

Perhaps the biggest change that taxpayers involved in the hospitality industry may encounter is that costs that were currently deductible may no longer be, and must be depreciated instead. The fact that individual building systems are now considered a unit of property as opposed to the building as a whole will greatly impact taxpayers who previously took an aggressive stance concerning expenditures associated with tangible property. This means that an expense that could have once arguably been deducted as a repair due may now be considered a capitalizable expenditure as it will almost always have a greater impact when examined for its effect on an individual building system as opposed to the building as a whole. For example, costs associated with the replacement of an HVAC compressor that may have once been deductible may now have to be capitalized, depending on the effect on the system as a whole. Similarly, the outlays required to return an elevator car to service could very well be considered a capital expenditure, depending upon the nature of the repair and to what extent it modifies the elevator system in its entirety.

The preamble to the new regulations states that they "are generally effective for amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012." Although taxpayers may not see the effect of these new regulations on taxable income until their returns for fiscal year 2012 are filed, proper accounting procedures should be put in to place as soon as possible to ensure that the returns conform to the new regulations. Additionally, taxpayers must consider that in many cases the implementation of the new regulations could require a Section 481 change in accounting method since the IRS is not allowing the new regulations to apply to the 2011 tax year.

Any taxpayer called upon to renovate, upgrade, replace and refurbish in the improved economy should consult with a tax advisor to understand the impact of these new regulations.