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IRS Sparks Confusion on Property Upgrades

New tax rules rekindle the repair versus improvement controversy.
Keith Button

New IRS rules for the tax treatment of repairs or improvements to property apply to nearly every company, starting this year. But most tax executives are still unsure about how these so-called repair regs will affect their businesses, according to a recent survey.

Of 1,900 tax executives surveyed by KPMG, 62% reported they were unsure whether to view the new regulations as favorable or unfavorable, while 23% saw them as favorable and 15% as unfavorable.

The January survey included executives who would typically report to chief financial officers, such as tax directors and tax managers, as well as C-level tax officers.

The repair regulations, released in December, dictate how companies must treat their costs of acquiring, maintaining, improving, and replacing tangible property. "It's going to affect anyone who has fixed assets, and that's everyone," says David Auclair, managing principal at Grant Thornton's national tax office in Washington, D.C.

One key issue addressed by the new IRS rules is whether an upgrade to a commercial building can be treated as a repair or an improvement, says Eric Lucas, a principal in KPMG's national tax practice in Washington and a former U.S. Treasury Department official.

The repair versus improvement issue has been a controversial one, says Lucas. The cost of a repair can be treated as a deduction in the tax year the repair is made, which generally is more attractive for the taxpayer. The cost of an improvement, meanwhile, must be capitalized and depreciated over the life of the asset — 39 years for a commercial building.

In the past, companies that adopted an aggressive interpretation of tax law would categorize expenses like roof replacements as repairs to their buildings, says Lucas. But the new repair regs clarify that each major system within a building must be considered separately — heating and air conditioning, plumbing, and electrical systems, for example — when determining whether a project is a deductible repair or a capitalizable improvement, he says. Generally speaking, upgrading a significant portion of one of those systems is considered an improvement, while a minor upgrade is a repair.

Companies that are overly aggressive on the repair versus improvement issue will have to adjust their cost calculations from previous years to line up with the new rules, which will have a negative impact on their tax position. "If you took the position that a lot of those expenses were repairs for tax (purposes), then you may have a compliance issue," says Lucas.

The repair regs will also allow some companies to file adjustments for past projects that will improve their tax positions, he says. Using the roof-replacement example: under previous IRS rules, the cost of a roof would be depreciated over 39 years, and the cost of the replacement for that roof would be depreciated over an overlapping 39-year period. Under the new rules, the old roof's remaining basis can be written off in the year it is replaced.

Two "revenue procedures" are expected from the IRS within the next month or so — clarifications on how to compute the adjustments required by the repair regs, says Lucas.

Because the repair regs are so comprehensive and can be applied retroactively, CFOs should make sure their firm conducts studies or reviews of asset repairs and capital-improvement projects to help determine its tax position, says Lucas. Most companies that follow generally accepted accounting principles are probably undercapitalizing their costs, he says.

The KPMG survey found 49% of the tax executives reported their company had never conducted an asset repair study, with 28% saying it had and 23% unsure.

Another significant change under the new repair regs is the de minimis expensing rule. Under that rule, a company can deduct the acquisition cost of property for tax purposes if that property was first tabulated as an expense for financial-reporting purposes, says Lucas. For example, a company may expense computers, equipment, furniture, and other items that cost less than $3,000. Previously, IRS rules required companies to capitalize and depreciate those items over their life spans, he says.

Both the de minimis expensing rule, which caps deductions at 0.1% of gross receipts or 2% of book depreciation, and the repair versus improvement rules require companies to begin tracking costs and asset information that they never have before, says Grant Thornton's Auclair. And they have to start now.

The new IRS rules apply to returns filed for tax years beginning on or after January 1, 2012, but companies should start estimating impact of the regulations in their quarterly financial statements and estimated tax payments, says Auclair.

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