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Capitalizing on the Repair Regulations, Part 2

By: Ezra Dyckman and Libin Zhang

New regulations in 2013 and 2014, commonly known as the Tangible Property Regulations or the Repair Regulations, established new rules on what expenses may be immediately deducted and what must be capitalized and depreciated over time. The new regulations provide detailed rules on what types of expenses must be capitalized under Code Section 263(a) as amounts paid out for "new buildings or for permanent improvements or betterments made to increase the value of any property" and for "any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made." The authors provided a brief description of the regulations in their Dec. 24, 2014 article in this column. This article addresses several issues on how owners of real property may use the regulations in practical terms.

Modicum of Clarity

Under the tangible property regulations, expenses that are a 'restoration,' 'betterment,' or 'adaptation' of a 'unit of property', as those terms are defined in the regulations, must be capitalized. Other expenses can be deducted as repairs. The new rules provide a modicum of clarity to an area that had historically been the source of much controversy and litigation. If an expense for a new property is capitalized, the taxpayer may elect to deduct its tax basis in the old property being replaced. This new "partial asset disposition election" concept may provide many real estate taxpayers with additional tax deductions.

The tangible property regulations are considered a change in the accounting method for the taxpayer that adopts them. A taxpayer who switches from an improper method of accounting (albeit proper when used at the time) to a proper method of accounting must file a Form 3115 and request IRS consent for the change, though consent is automatic in most circumstances.[1] The Form is required even if the new accounting method is mandatory. Each "trade or business" of the taxpayer, such as each single-member LLC wholly owned by the taxpayer (according to the instructions to Form 3115), must separately change its accounting method on a separate Form 3115, though multiple trades or businesses are allowed to aggregate their changes on a single Form 3115. A failure to file Form 3115 may result in certain audit risks. The IRS should not be surprised to receive a huge number of 3115 forms over the next few months as taxpayers scramble to adopt the regulations.

When a taxpayer adopts a new method of accounting, the taxpayer is generally treated as having been using the new method of accounting all along, even for prior tax years. The taxpayer claims a "catch-up" tax deduction (or taxable income inclusion) under Code section 481 to correspond to the new method. As a result, a taxpayer who adopts the new tangible property regulations should calculate the excess of the deductions over the years that it would have had, had it been using the new regulations all along, over the deductions actually claimed, and that difference is taken as a lump sum deduction in the year of the method change. For example, a taxpayer who started operating a rental real estate business in 1990, had historically taken conservative repair tax positions, and adopted the new regulations starting in 2014, should calculate what would have been its additional tax deductions for the years 1990-2013 under the new regulations. For example, certain windows replaced in 2002 that were originally capitalized, 'should' have been deducted under the new regulations, which means that the remaining tax basis of the windows in 2014 can be claimed as an immediate deduction in 2014. The deductions are claimed as a Code section 481 negative adjustment, which reduces the taxpayer's ordinary income, in 2014 by filing Form 3115.[2] It does not matter that the statute of limitations for 2002 had already closed.

The new regulations should generally result in increased tax deductions for many real estate taxpayers. Although the Code section 481 adjustment may reduce the taxpayer's taxable income, they do require the taxpayer to review its books and analyze its repairs from many earlier

***Ezra Dyckman** is a partner in, and **Libin Zhang** is an associate of, the law firm of Roberts & Holland LLP.*

years at significant administrative time and expense. If a taxpayer were to choose to not review its past records and to claim no additional deductions for expenses of prior years, the IRS could theoretically take the position that the taxpayer's tax basis in its assets should nevertheless be reduced by the foregone deductions that the taxpayer should have taken, with the result that the taxpayer has less future depreciation plus additional gain upon the disposition of the assets.

IRS Comments

At an American Institute of Certified Public Accountants meeting in Washington, D.C. on Nov. 5, 2014, the commentators noted that some taxpayers were reluctant to bear the high expenses associated with reviewing their old records to calculate a precise Code section 481 adjustment, and that the taxpayers were considering filing their Forms 3115 showing a zero adjustment. Scott Dinwiddie, special counsel at the IRS Office of Associate Chief Counsel (Income Tax and Accounting), stated that the IRS was unlikely to have much interest in examining a taxpayer's zero adjustment under Code Section 481, except in situations where the taxpayer took aggressive positions in the past or had in no way applied a proper capitalization method. Andrew Keyso Jr., another IRS official, reiterated that the government will likely respect a taxpayer's Form 3115 even though the zero adjustment was incorrect, unless it was clear that the adjustment should have been a much different number.

The IRS officials' informal comments gave practitioners some comfort that taxpayers were not required to perform a full review of all of their past records in order to file the Form 3115. But it was uncertain how much reliance could be placed on those comments. It was also unclear whether a taxpayer could take a half-way position, such as going back only a certain number of years, rather than filing a Form 3115 with zero adjustments.

The IRS in February 2015 issued Revenue Procedure 2015-20, 2015-9 IRB 694, which created new procedural rules applicable to "small business taxpayers." Such taxpayers are explicitly permitted to file their Form 3115 showing $0 as their Code Section 481 adjustment. In other words, the small business taxpayers are permitted to apply the new tangible property regulations only going forward, for expenses incurred after January 1, 2014, without having to review their old records from previous years. The taxpayer would no longer need to review whether the windows it replaced in 2002 should have been deducted under the new rules.

Rev. Proc. 2015-20 separately applies to each "trade or business" of a taxpayer. The trade or business would qualify to file a Form 3115 with no adjustment if:

(1) It has total assets of less than $10 million (as of the first day of the tax year that adopts the tangible property regulations), or

(2) It has average annual gross receipts of $10 million or less for the prior three taxable years.

A trade or business that meets either one of the above tests qualifies under Rev. Proc. 2015-20, even if the taxpayer has other trades or businesses that do not qualify.

The $10 million gross receipts test should include many real estate businesses. Gross receipts are not reduced by costs of goods sold for inventory assets, but gross receipts are reduced by the tax basis of sold capital assets or property used in a trade or business. Gross receipts do not include receipts reinvested in a section 1031 exchange.

It is unclear how the promulgation of Rev. Proc. 2015-20 affects the earlier informal comments by IRS officials on how all taxpayers may be able to file Forms 3115 with zero adjustments. Is the revenue procedure an exclusive route that, by implication, suggests that larger businesses must file their Forms 3115 with the correct adjustments? Or is it merely a safe harbor that does not preclude other businesses from taking the administratively simpler route of filing with zero adjustments? Can small business taxpayers take the half-way position, of claiming some adjustments but not all, or do they all have to file Forms 3115 showing only zero adjustments? The revenue procedure provided important guidance but left many questions unanswered.

As a policy matter, the informal IRS position that all taxpayers should be able to claim zero adjustments on their Forms 3115, barring egregious circumstances, is the preferable stance. Larger taxpayers may also lack the desire to undertake the administrative expense of going through their old records and re-evaluate their repair versus capitalization decisions, particularly if the relevant personnel are no longer with the company. There are many uncertain legal issues within the new regulations that certain taxpayers might not have the time or corporate focus to address diligently. Other taxpayers might prefer a policy of relatively stable taxable income each year and not find a large one-time tax deduction to be useful. The IRS hopefully should not challenge taxpayers who are foregoing tax deductions that they otherwise may be entitled to, especially when IRS will have its hands full with all the Forms 3115 submitted by those taxpayers who are eager to claim their tax deductions.

[1] See Rev. Proc. 2014-16, 2014-17, and 2014-54.

[2] If the taxpayer instead had a positive Code Section 481 adjustment, because the taxpayer's historical tax positions were more aggressive than the new regulations, the positive adjustment would increase the taxpayer's taxable income in 2014. The taxpayer may spread the income increase over four years.