Deductions & Depreciations

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The IRS allows rental property owners to deduct repairs and depreciate improvements. How can landlords make the most of it?

As summer ends and autumn arrives, daylight fades earlier and the weather gets cooler. The leaves turn into a beautiful array of colors. This is the time of year to prepare your property for winter. What is on your list for fall maintenance?

Are you checking your heaters and replacing dirty air filters? Clearing out clogged gutters and checking for leaks in your outdoor water valves? How about checking for cracked or damaged weather stripping in doorways?

Owning property is a dream for many Americans, and the IRS rewards rental property owners by allowing deductions for repairs and allowing them to depreciate improvements. So, how can landlords make the most of it?

Repairs v. Improvements

Repairs help keep the property in efficient operating condition and restore the property to its previous condition. They also protect the property through routine maintenance and incidental repairs. To be considered a "repair" expenditures should not add significant value to the property or extend its life.

According to I.R.C. § 162, property owners are allowed the deduction of all ordinary and necessary expenses that are incurred during the taxable year. These expenses include the cost of repairs and maintenance. Some examples of repairs are fixing plumbing leaks, replacing broken doors, repairing leaks in a roof, or patching up cracks in the floor.

However, I.R.C. § 263(a) requires capitalizing the costs of acquiring, producing, and improving tangible property. Improvements are anything that increases the value of the property or extends its life. This type of improvement is categorized as a "capital expenditure" and must be depreciated over the course of its useful life. Improvements can be anything from replacing a roof, renovating a kitchen, rebuilding a piece of machinery, or remodeling a building.

The general rule of thumb is that "improvements" are considered when adding a new item or upgrading an existing item.

Why Is This important?

When you are making repairs to your rental unit or building, you are able to deduct the cost of repairs in a single year, while you have to depreciate improvements over as many as 27.5 to 39 years.

Let's look at a scenario: Jon Doe spends $1,000 painting the walls of a studio apartment. This is considered a "repair" and it qualifies as a deduction that Jon can take in the year he incurs this expense. Let's say Jon spent $1,000 renovating his bathroom floor by replacing the entire floor. This is considered an "improvement." Jon will have to depreciate this over the course of 27.5 years and will only get a $35 deduction in the year this was incurred.

Big difference, right? But why are the rules so different? The assumption is that "improvements" will add value to the property over multiple years, not just the current year in which you make the improvements. Thus, the reason you cannot deduct the entire amount in a single year.

The "Improvement" Test

Let's dig into this a little more deeply. When is property improved? I mentioned earlier that the general rule of thumb is that "improvements" are considered when adding a new item or upgrading an existing item.

On January 1, 2014, the IRS released a new regulation governing the deductibility of repairs and improvements to a business property. The regulation also provided a safe harbor for amounts paid for routine maintenance of property and an election to capitalize certain deductible expenses.

A taxpayer must generally capitalize anything that improves property if the changes result in betterment, adaptation, or restoration ("BAR").

What Is Betterment?

First, we must consider all facts and circumstances to determine what betterment is. Think about the purpose of expenditures, the effect of the expenditures on the property, and the taxpayer's treatment of the expenditures on the applicable financial statement.

Betterments include expenditures that materially improve the productivity, strength, quality, or output of the unit of property; represent a material addition to the property or asset, such as a physical enlargement; or correct a material condition or defect that existed prior to acquisition or that arose during production of the property.

If the expenditure adds additional economic life to the property, it generally should be capitalized.

Let's look at some examples of betterment. A taxpayer adds expansion bolts to a building that is located in an earthquake-prone area. These bolts anchor the building frame to its foundation, providing additional structural support and resistance to seismic forces. The costs to add these expansion bolts would be an improvement because they increase the strength of the building structure. This is an example of material increase in strength.

A taxpayer adds a stairway and loft to a retail building to increase its selling space. Costs to build the stairway and loft are for an improvement because they materially increase the capacity of the taxpayer's building structure. This is an example of a material addition.

A taxpayer acquires land with a leaking underground storage tank left by a previous owner. The costs to clean up the land would be an improvement because they fix a material condition or defect that arose prior to the acquisition. This is an example of amelioration, which is a betterment because it fixes a material condition or defect.

What Is Adaptation?

Under the adaptation category, expenditure will result in capitalization if the adaptation is not consistent with the taxpayer's ordinary use of the property when it was placed into service.

Let's look at an example. A taxpayer owns a building that is used to manufacture items for several years, beginning when the building was placed in service by the taxpayer. The taxpayer decides to convert the manufacturing building into a showroom through modifications to the building structure and various building systems. Costs to convert the manufacturing building into a showroom are improvements because the structure and systems are converted to a new or different use that is inconsistent with the intended ordinary use of the building (manufacturing items) at the time it was placed in service.

What Is Restoration?

To determine if any of your expenditures fall within this category, it is appropriate to consider all the facts and consequences. A replacement of a minor component of the property will not, by itself, constitute a major component or substantial structural part.

A restoration must be capitalized if the property is being rebuilt to a new condition after the end of its class life. If an expenditure is used to restore the property for replacement of a part or that comprise a major component or substantial structural part of the property, it must also be capitalized. If you are working on restoring property to return it from a state of nonfunctional disrepair or replacing a component after a casualty loss, this is considered restoration and must be capitalized.

Let's look at some examples of restoration. A taxpayer operates a farm with several out-buildings. The taxpayer did not use or maintain one of the out-buildings on a regular basis, and the out-building fell into a state of disrepair. It could no longer be used in the taxpayer's business. The taxpayer decides to restore the building by shoring the walls and replacing siding. These costs are for restorations, and therefore improvements, because the building was returned to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use. This is considered an example of deterioration to a state of disrepair that requires restoration.

A taxpayer owns a fleet of vehicles. After the end of the class life of each vehicle, the taxpayer disassembles and rebuilds each vehicle according to the manufacturer's original specification. Costs paid to rebuild each vehicle are for restorations, and therefore improvements, because each fleet vehicle is restored to a like-new condition after the end of its class life.

The "Repair" Test

If a taxpayer fails the "BAR" tests, the expenditures may qualify as a deductible repair. As from the aforementioned, repairs should not add significant value to the property or extend its life.

Safe Harbor Election

Regs. Sec. 1.263(a)-3(h) provides that if you have an annual gross income of $10 million or less for the prior three years, you can elect for the de minimis safe harbor to deduct certain expenditures for your business property. When you elect for the de minimis safe harbor, you will be deducting the expenditures for your business property rather than capitalizing the assets. The de minimis safe harbor can be elected on an annual basis to expense all items under a certain amount with a useful life of 12 months or less.

Under the de minimis safe harbor rule, taxpayers with applicable financial statements can deduct up to a $5,000 threshold and taxpayers without applicable financial statements can deduct up to $2,500.

Advice to Heed

In conclusion, take into consideration your list for fall maintenance. As you think about changing out the furnace filters in each unit, checking for leaks under the sinks, and making sure the garbage disposals are in working order, think about how the IRS examines "repairs and maintenance" costs as well as "improvement" costs.

Keep track of every business expense to ensure you have records of your applicable financial statements. It is absolutely crucial to have documentation if the IRS ever audits your business.

Taking deductions can make quite a difference when it comes to reducing taxable income and retaining more of the cash flow. There are many taxpayers out there who will try to expense items that should be depreciated, simply because they are not clear on the differences. Our tax law is complex but also objective. This is why it is so important to work closely with your Certified Public Accountant (CPA) or tax professional.

Every client has a situation that is different and unique. Your accountant should understand your needs and the services you provide. A great CPA or tax professional will make sure you and your business are taking full advantage of the ever-changing tax laws. They will work with you on your tax planning and help create tax strategies to fit your needs.

The above is the basic rule in its simplest form for general information purposes; as such, it is not an authority to rely on in making tax decisions. Consulting with your tax advisors is highly recommended. Jargal Oyunbileg is a CPA at Shwiff, Levy & Polo, LLP. She enjoys going on short hikes, eating dim sum, and picking pine nuts in Mongolia. She can be contacted at jargal@yousrvc.com.