



Welcome, to the **Real Estate Connection!**

topics: Tax Planning Update
Fixed Asset Training Course



PERKINS & CO

Real Estate Practice Group presents:

A Changing Tax Landscape

"What to do now to ensure tax savings"

Tim Kalberg, CPA
Shareholder



déjà vu anyone?

**Weren't we here a
year ago?**



Real Estate Practice Group

the
HOUSE

SUPERHEROES OF THE SUPER COMMITTEE

the
SENATE



FRED UPTON
(MI)



JEB HENSARLING
(TX)



DAVE CAMP
(MI)



CO-CHAIR

SUPPORT OF
KEY BILLS



'10 BUSH
TAX CUTS



CASH FOR
CLUNKERS



'09 OBAMA
STIMULUS



TARP



FANNIE/
FREDDIE
BAILOUT



'06 TAX CUT
EXTENSION



FARM
SUBSIDIES



PAT TOOMEY *
(PA)



JON KYL
(AZ)



ROB PORTMAN *
(OH)



JAMES CLYBURN
(SC)



XAVIER BACERRA
(CA)



CHRIS VON HOLLEN
(MD)



PATTY MURRAY
(WA)



MAX BAUCUS
(MT)



JOHN KERRY
(MA)

* No recent key votes



YIKES!!!

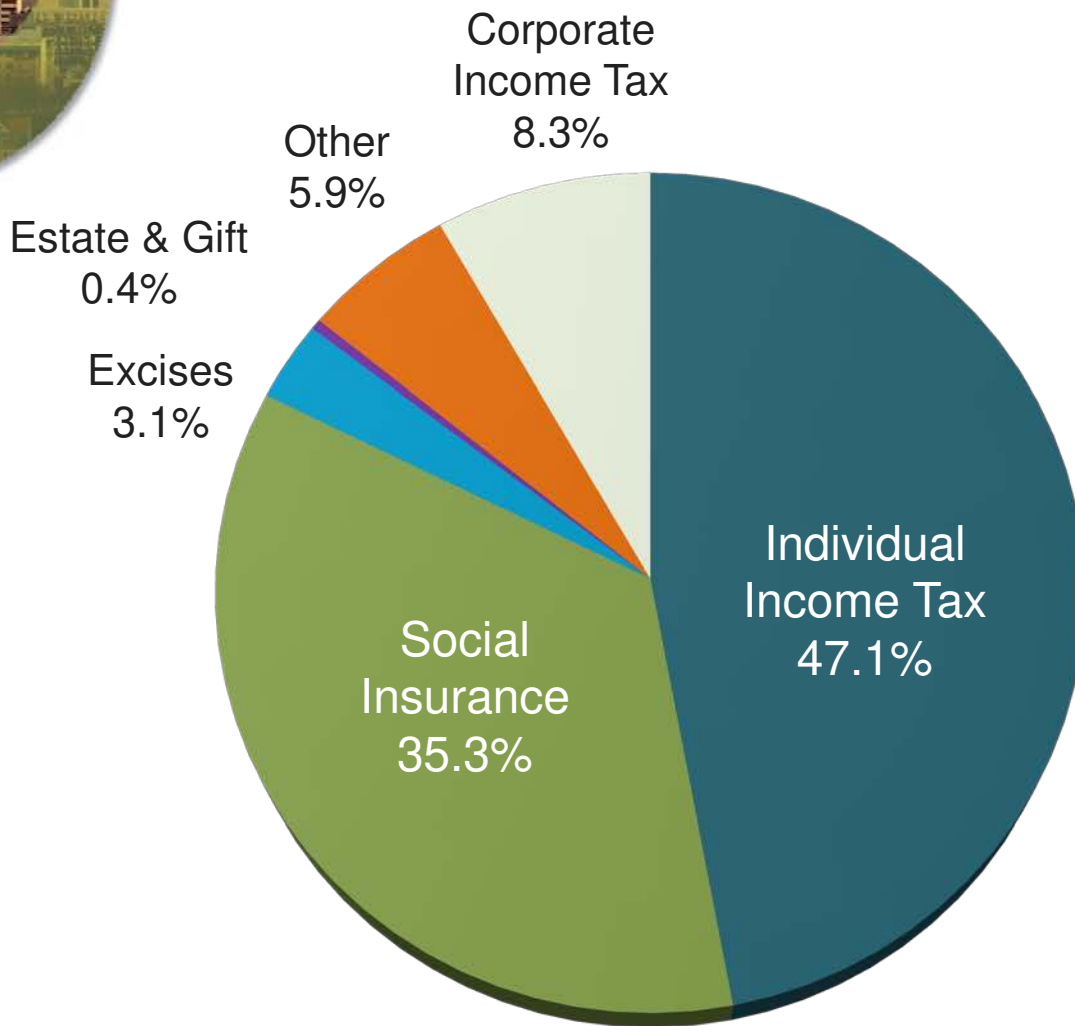
**I have how long
to save???**



Agenda

- **Current IRS Audit Activity**
- **Current Tax Landscape**
- **Future Tax Landscape**
- **Lease Accounting Update**
- **Planning, Planning, Planning!**

Federal Government Funding Sources



Current IRS Audit Activity

Recent individual IRS audit rates:

- All taxpayers 1.1%
- >\$1 Million 8.4%
- >\$10 Million 18.4%





Current IRS Audit Activity

- **Passive activities in general, and MPREP in particular**
 - **Activity classification and groupings**
 - **Aggregation election for MPREP**

Real Estate Professionals ➡
LOG YOUR TIME!!!



Current IRS Audit Activity

- Home mortgage interest deduction limitations
- Foreign income reporting and compliance (cross-checking with banks)
- New for 2011: cross-checking reported income with credit card records
 - Do they match?
 - Schedule C filers beware



Current IRS Audit Activity

- **Gift taxes – checking state records to dig up unreported property transfers**
- **S corporations**
 - **Shareholder/employee reasonable compensation**
 - **Sufficient tax basis**



Current IRS Audit Activity

- **Partnerships/LLCs**
 - Self-employment taxes
 - Sufficient tax basis
- **New IRS audit guides are coming out**
 - Architects just won this lottery
- **More targeted audit approach and more funding for enforcement**



Federal Estate/Gift Tax

Federal	2011	2012	2013
Annual Gift Exclusion	\$13,000	\$13,000	\$13,000(est)
Lifetime Gift Exemption	\$5,000,000	\$5,000,000	\$1,000,000
Lifetime Estate Exemption	\$5,000,000	\$5,000,000	\$1,000,000
GST Lifetime Exemption	\$5,000,000	\$5,000,000	\$1,000,000
Portability	Yes	Yes	No
Top Rate	35%	35%	55%

State Estate/Gift Tax



	2011	2012	2013
Oregon			
Lifetime Estate Exemption	\$1,000,000	\$1,000,000	\$1,000,000
Top Tax Rate	16%	16%	16%
Washington			
Lifetime Estate Exemption	\$2,000,000	\$2,000,000	\$2,000,000
Top Tax Rate	19%	19%	19%



Top Income Tax Rates

	2011	2012	2013
Ordinary Income	35%	35%	39.6%
Qualified Dividends	15%	15%	39.6%
Capital Gains	15%	15%	20%
Depreciation Recapture	25%	25%	25%
Oregon	11%	9.9%	9.9%



High-Income Taxpayer Increases for 2013

○ Medicare hospital insurance (HI) tax

- Additional 0.9% on employee portion of wages in excess of \$200,000/\$250,000 for singles/joint filers

○ Surtax on “investment income”

- 3.8% on investment income where AGI is in excess of \$200,000/\$250,000 for single/joint filers
- Investment income - taxable interest, dividends, rents, royalties and other non-wage income
- Business income & rental income classified as passive activities count too!



Prospects for The Future

- **President Obama's Jobs Growth & Long-term Deficit Reduction Plan**
- **House Democratic Members of the Joint Special Committee**

President Obama's Proposal

○ The Good 😊:

- 100% bonus depreciation extension
- Social security tax cuts for both employers & employees
- Enhanced credits for hiring unemployed/disabled veterans
- Credits for hiring the unemployed
- Roll back gift/estate tax provisions to 2009 levels after 2012 (connectivity?)

President Obama's Proposal

○ The Bad ☹️:

- Bush tax cuts expire for taxpayers with household income above \$250,000
- “Buffet rule” codified
- Carried interest taxation

President Obama's Proposal

○ The Bad ☹️, continued:

- Restriction/elimination of certain inventory tax accounting methods
- Restore FUTA payroll taxes to 0.8%
- Higher funding to IRS for enforcement and audits



JSC House Democratic Members' Proposal

○ The good 😊: ???

○ The bad 😞:

- 5% surtax on “tax expenditures”
- 5.4% surtax on high-income individuals
- Accelerate repeal of Bush tax cuts by 1 year (2012)
- Restrict discounting for entity interest transfers

JSC House Democratic Members' Proposal



○ The bad ☹️, continued:

- Revert estate/gift tax rules to 2009 levels in 2012
- Slow down tax depreciation by requiring ADS lives/methods instead of MACRS
- Restrict service business use of S-corporations to mitigate self-employment taxes



Planning Strategies

- **Maximize deductions on fixed assets**
 - Bonus depreciation
 - Qualified leaseholds in-service by end of 2011
 - Cost segregation
 - Repairs & maintenance
 - Section 179 deduction
 - Section 179D deduction



Tax Act Depreciation Benefits – Bonus Depreciation

In Service Date	2008-2010	2010-2011	2012
Bonus Depreciation	50%	100%	50%
Phase In Date	1/1/08	9/9/10	1/1/12
Phase Out Date	9/8/10	12/31/11	12/31/12

- Oregon – no bonus in 2009 & 2010
- California – no bonus ever



Tax Act Depreciation Benefits – Qualifying Leasehold Improvements

In Service Date	2011	2012
Depreciable Life	15 yrs	39 yrs
Phase In Date	N/A	N/A
Phase Out Date	N/A	N/A
Bonus Depreciation?	Yes	YES

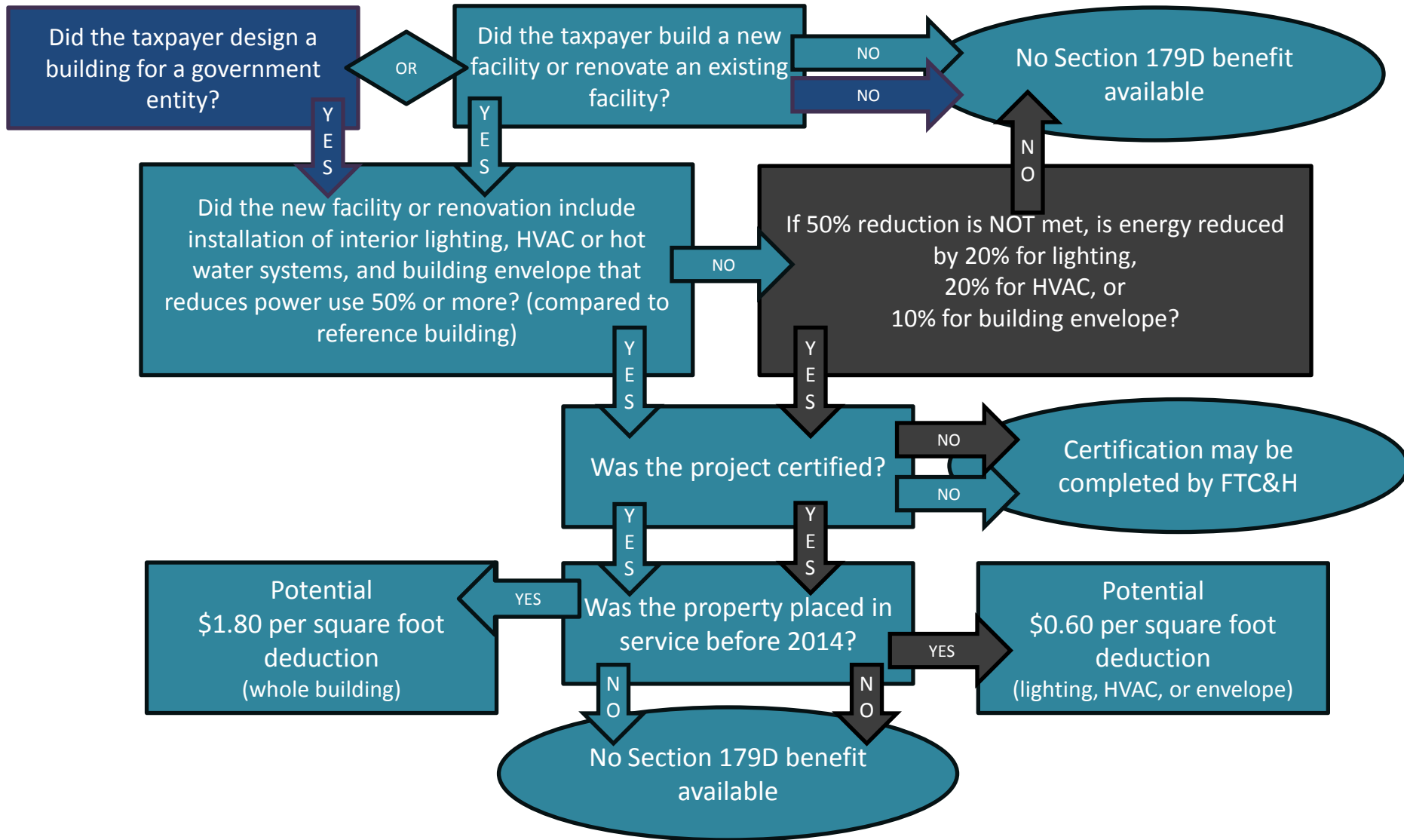
- Improvements must be pursuant to a lease
- No common area/structural improvements
- No related party leases
- Building must be at least 3 years old



Energy Deduction 2008-2014

- **Sec. 179D Deduction for Energy Efficient Commercial Buildings placed in service before 1/1/2014**
- **Immediate deduction of up to \$1.80/sf, \$0.60/sf each for lighting, HVAC & shell**
- **Basis reduction required, except for pass-through option**
- **Certification is required**
- **LEED doesn't guarantee qualification**

Energy-Efficient Commercial Building Deduction – Section 179D





Lease Accounting Rules Update

- **Background of proposed changes**
- **Current status**
 - Lessee, leases on balance sheet
 - Lessor, single approach with carve-out for investment properties
 - New exposure draft expected first half of 2012



Planning Strategies

- **Personal income tax strategies:**
 - Lock in capital gains?
 - Lock in qualified dividends?
 - Passive activity reporting and grouping
 - COD planning
 - Loss limitation planning
 - Retirement plan distribution planning



Planning Strategies

- **Estate planning strategies:**
 - Family limited partnerships
 - Defective grantor trust sales
 - GRATs
 - Partnership freezes
 - Intra-family loans
 - Don't lose sight of basis reset



Planning Strategies

○ Other strategies:

- Profits interest & Sec 83b election
- Carried interests
- Expiring tax provisions

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Real Estate Practice Group



FIXED ASSET TRAINING COURSE

September 2011

Agenda

- Bonus depreciation
 - 100 %bonus depreciation
 - Self-constructed property
 - Other considerations
- Repairs and maintenance
 - General rules
 - Proposed Regulations
 - Examples
- Questions and answers



Bonus Depreciation

Bonus Depreciation – General Rules

Property
Type

Original
Use

Acquisition
Date

Placed in
Service

Bonus Depreciation - 100% Bonus Requirements

- Requirements to claim 100% bonus depreciation
 - Must meet the requirements of §168(k)(2);
 - Original use of the property must commence after September 8, 2010;
 - The property must be placed in service after September 8, 2010 and before January 1, 2012 (January 1, 2013 for certain long production period and transportation property); and
 - The property must meet the special acquisition rules of Rev. Proc. 2011-26

Acquisition Definitions

- Solely for purposes of 100% bonus depreciation: a taxpayer is considered to acquire qualified property when the *taxpayer pays* (cash basis taxpayer) *or incurs* (accrual basis taxpayer) the cost of the property
- Binding contract definitions remain unchanged
 - Binding only if enforceable under state law against the taxpayer, and
 - Does not limit damages to a specified amount

Self-Constructed Property

- Application under IRC § 168(k)(2)(E)(i):
 - In the case of a taxpayer manufacturing, constructing, or producing property for the taxpayer's own use, the requirements of clause (iii) of subparagraph (A) shall be treated as met if the taxpayer begins manufacturing, constructing, or producing the property after December 31, 2007, and before January 1, 2013.
- Definition under Treas. Reg. § 1.168(k)-1(b)(4)(iii) differs from definition elsewhere:
 - Property that is manufactured, constructed, or produced for the taxpayer *by another person* under a written binding contract (as defined in paragraph (b)(4)(ii) of this section) that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business (or for its production of income) is considered to be manufactured, constructed, or produced by the taxpayer.

Acquisition Rules for Self-Constructed Property

- When physical work of a significant nature begins
 - Depends on the facts and circumstances
 - Physical work does not include preliminary activities

- Safe harbor
 - Physical work of a significant nature will not be considered to begin before the taxpayer incurs (accrual basis taxpayer) or pays (cash basis taxpayer) more than 10% of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching)

 - When property is manufactured, constructed, or produced for the taxpayer by another person, this safe harbor test must be satisfied by the taxpayer

Bonus Depreciation – Other Considerations

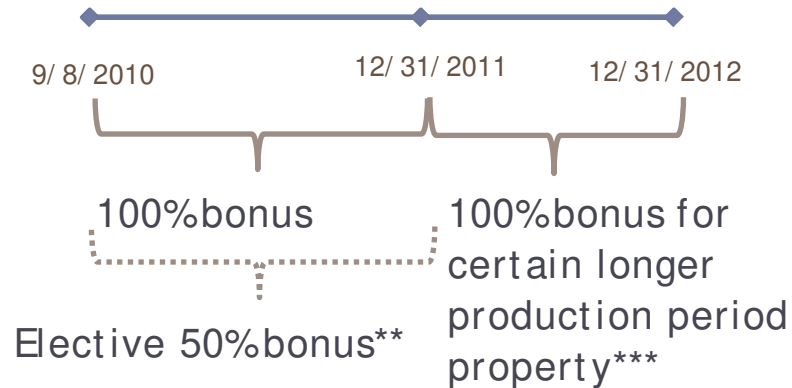
- Components of self-constructed property
 - Election for components that qualify where the larger self-constructed property does not qualify
- Election required for not claiming bonus depreciation or claiming 50% instead of 100% bonus in 2010
- Bonus depreciation applies automatically unless elected out
- Bonus depreciation applies for AMT purposes
- Mid-quarter convention determined taking into account the depreciable basis eligible for bonus depreciation
- Possible adverse effects
 - §199 deduction
 - §382 limits
 - Will accelerate income for purposes of §460 (long-term contracts)

Bonus Depreciation (Con't)

Property qualifying for 50%bonus, but not 100%bonus



Property qualifying for 100%bonus



*Amount eligible for 50%bonus limited to adjusted basis as of 12/31/2012

**Election available only for taxable year that includes September 9, 2010

***Amount eligible for 100%bonus includes amounts paid or incurred before 12/31/2012



Repairs and Maintenance

Current Law

Key Benefits

- Cash flow benefit
 - Time-value benefit from deferral of federal and state tax payments
 - Reduced federal and state estimated tax payments provides immediate cash-flow benefit
 - Carryback opportunity may result in tax refunds
 - Federal benefits = cash equal to 5% of tax plant ledger adjusted basis + time value
- Opportunity to identify and correct other fixed asset errors – clean up fixed-asset ledger
- Opportunity to identify other fixed-asset-based opportunities such as state tax credits and traditional cost segs.
- Create a roadmap for correctly classifying property in future years
- §199
- Can be achieved with minimal disruption to the taxpayer's staff

Automatic Change in Accounting Methods

- IRS Guidance
 - Revenue Procedure 2011-14 - For Capital vs. Expense issues
 - Revenue Procedure 2011-14 – For changes in tax recovery periods (for example 39 year to 5, 7 or 15 yrs)
- Separate Form 3115s and separate Section 481(a) adjustments are required.
- Guidance from the Internal Revenue Service provides opportunities to “catch-up” missed deductions on a current year return.
- IRS has indicated it may not allow a Sec. 481(a) adjustment or may provide a limited Sec. 481(a) adjustment in the repairs final regulations.

Automatic Change in Accounting Methods

- Automatic Procedure
 - Rev. Proc. 2002-19 modified Rev. Proc. 2002-9 and allows taxpayers to “catch-up” the missed depreciation in the year of change (1 year catch-up instead of 4 year spread)
- Form 3115 must be filed by the due date of tax return (including extensions)
- Three window periods for taxpayers under examination:
 - 90 day window
 - 120 day window
 - Operating Division Director Consent



Phase I Analysis

- Phase 1 is the process of estimating the potential value to be derived by conducting an in-depth analysis of the taxpayers' field/plant asset ledger.
- After completing Phase 1, the main goals are to be able to:
 - Provide a reasonable estimate of the tax savings associated with completing a project;
 - Identify the assets, within the population of assets reviewed, that account for most of your projected benefit;
 - Determine the best approach for completing the job (full reviews vs. statistical sampling); and,
 - Estimate the time needed to complete the project.

Phase I – Information Request

- A copy of the company's most recent federal tax depreciation ledger (preferably an electronic file). The ledger should include:
 - Asset number,
 - Description of asset,
 - Tax life,
 - Tax cost basis,
 - Bonus depreciation (if applicable),
 - Placed in service date,
 - Accumulated tax depreciation,
 - Retirement code (if applicable),
 - Property Location, and
 - Net Tax Value
- If applicable, a copy of "offline" manual adjustments to the ledger.

Phase I – Calculate Section 481(a) Adjustment and NPV

- Calculate tax deductions for costs using current methods and revised methods to determine the current tax year “catch-up” deduction. This “catch-up” adjustment is the Section 481(a) adjustment.
- The ability to accelerate deductions is a timing issue. The value to the taxpayer can be measured by calculating the net present value of the stream of current and future changes to tax deductions.
 - To calculate the Net Present Value of the tax benefits, you should ask the taxpayer to provide :
 - their effective tax rate
 - a reasonable discount rate

Phase II – Implementation Phase

- Calculate tax deductions for costs using current methods and revised methods to determine the current tax year “catch-up” deduction and potential net present value tax benefit
- Coordinate with the Accounting Methods Group to prepare the two automatic 3115s “Change in Accounting Method”
- Prepare the deliverable (DVD) which should include:
 - An executive summary
 - Methodology
 - The project results
 - Forms 3115 and related attachments
 - Schedule of assets changed to being expensed
 - Supporting documents (invoices, other backup)
- Meet with the company to present the results
- Conduct a training session to educate company personnel

Fixed Asset Reviews – The Opportunity

- Our expertise has proven that personal property is often “buried” in the cost of buildings and leasehold improvements. This “misclassification” of property triggers the loss of significant tax deductions.
- As much as 40% of the construction costs related to taxpayers’ office buildings, retail space, manufacturing facilities and/or leasehold improvements could potentially be under-depreciated.



Fixed Asset Reviews – Examples of Commonly Misclassified Assets

- Non-permanent floor coverings
- Non-permanent wall coverings
- Decorative millwork
- Appliances/ equipment hook-ups
- Telecommunications cabling
- Land improvements (sidewalks, fences)
- Window coverings (blinds, drapes)
- Signage
- Electrical/ plumbing costs for certain equipment
- Indirect Costs

Fixed Asset Reviews – Categories

- Guidance issued by the courts, Congress and the Internal Revenue Service has defined the type of costs which fall within the following categories under the current Modified Accelerated Cost Recovery System (MACRS) used to depreciate assets for Federal tax purposes:
 - Land
 - Land Improvements
 - Building/Leasehold Improvements
 - Tangible Personal Property

Descriptions of Categories

■ Category 1 – Land

Costs properly classified as land include the purchase price, closing costs general permit fees and other compliance related charges incurred to acquire undeveloped earth. For tax purposes, land costs are non-depreciable.

■ Category 2 – Land Improvements

Land improvement costs include improvements directly to or added to land, whether such improvements are real or tangible personal property, provided such improvements are depreciable. Examples include:

- ✓ Driveways
- ✓ Sidewalks
- ✓ Roads
- ✓ Retaining walls
- ✓ Irrigation
- ✓ Pavement
- ✓ Fences



Generally, under MACRS, land improvements are assigned a recovery period of 15 years.

Descriptions of Categories

- Category 3(b) – Leasehold Improvements

Generally for Federal income tax purposes, depreciation on leasehold improvements is computed the same way as depreciation on property owned by the taxpayer. Thus, this sub-category generally includes the same costs as found under the building category.

Note, however, that a 15 year recovery period (using a straight-line method and half-year convention) applies to qualified leasehold improvement property placed in service between October 23, 2004 and December 31, 2009 (Code Sec. 168(e)(3)(E)(iv) as amended by P.L. 110-343, (b)(3)(G), and (g)(3)(B)). The improvements must be made to the interior portion of nonresidential real property that is at least three years old by the lessor or lessee under or pursuant to the terms of the lease.

Descriptions of Categories

- **Category 4 – Tangible Personal Property**

The income tax regulations define “tangible personal property” as “any tangible property except land and land improvements thereto, including buildings or other inherently permanent structures (including items which are structural components of such buildings or structures)”, and further, as “all property that is in the nature of machinery (including property attached to or located outside the building.”

Depending on the type of tangible personal property and how it is used, tangible personal property could be assigned a recovery period ranging from 3 to 20 years.



Distinctions – Tangible v. Real Property

- Functionality
- Portability
- Exceptions



Functionality

- One of the fundamental considerations is whether the asset primarily functions as an essential component of the building or functions as an asset used in the business conducted within the building. Assets that function as a component of the business are more likely to qualify as tangible personal property than those that primarily serve the operation and maintenance of the building.
- Also, if the property is so inextricably linked to another asset, so that it would be contemporaneously retired with that “linked asset, then they will be assigned the same depreciation period. For example, certain electrical wiring may be dedicated to a machine and will be retired if the machine is also retired. This electrical wiring will thus be assigned the same life as the machine it serves. Further, if the sole justification of the installation of an asset is the fact such property is required to meet temperature or humidity requirements that are essential for the operation of other equipment or for processing needs, it is not considered to be a building component (even if it incidentally serves a building function).

Functionality - Question



Based on the previous statements, which of the following item(s) may qualify for a shorter recovery period based on functionality?

- A. Drywall
- B. Dedicated HVAC for the computer server room
- C. Uninterruptible power supply for a computer room
- D. Elevators
- E. Concrete foundations used to support heavy equipment, such as a back-up generator

Functionality - Answer

Answer:

B, C, and E may qualify for a shorter recovery period based on functionality.

Portability

- For purposes of identifying tangible personal property, portability refers to the ability of an asset to be removed from its current location without excessive damage to the underlying real property.
- For example, when carpeting and vinyl wall covering are installed in such a way that they are not an integral part of the floor or wall themselves, and are installed in a manner to be readily removed, the courts have determined that they are tangible personal property.
- The element of portability lends more support to an asset's qualification as tangible personal property.

Portability – Points to Consider

- Is the asset capable of being moved?
- Is the asset designed to remain permanently in place?
- What is the manner of affixation?
- If affixed, what is the intended length of affixation?
- How difficult would it be to remove the asset?
- What is the removal effort and what potential damage would result from the removal?



Portability – Question



Which of the following items may qualify for a shorter recovery period based on portability?

- A. Carpeting
- B. Lab casework
- C. Acoustical ceiling tiles
- D. Steel supports for a high density storage system

Portability – Answer

Both A and B may qualify for a shorter recovery period based on portability.

While acoustical ceiling tiles can be easily removed, the IRS believes the tiles relate to the operation and maintenance of a building and are designed to remain in place permanently.

Steel supports for a high density storage system may qualify for a shorter recovery period, but functionality, rather than portability, would be the determining factor.

Permanence is not a consideration for asset classification when the property in question is in the nature of machinery and/or equipment (or is inextricably linked to the machinery).

Exceptions

- The following examples are items that do not qualify as tangible personal property:
 - Bathroom Accessories
 - Acoustical Ceiling Tiles
 - General Purpose Fire and Safety Equipment
 - Domestic HVAC Units (primarily for employee comfort)
 - Hot Water Heaters



Treatment of Indirect Costs (“Soft Costs”)

- Indirect costs are typically associated with a construction project but they are not directly linked to any specific asset.
- Examples of Indirect Costs include:
 - General Requirements (temporary facility, utilities, cleanup costs)
 - Architectural Fees
 - Engineering Fees
 - Insurance
 - Contractor’s Overhead, Profit, and Other Project Service Fees
- These costs are typically allocated among the types of property (tangible personal property v. real property) based on a reasonable method of allocation.
- In certain instances, the indirect costs will be assigned to a specific category. For example, landscape design fees should be recovered over the same period as the landscaping that it relates to.

Other Tax Guidance That Impacts the Tax Recovery Lives

- Removal Costs
- Qualified Leasehold Improvements



Removal Costs – Revenue Ruling 2000-7

- Costs incurred in removing a retired asset are not required to be capitalized under Section 263 provided the removal of the depreciable asset occurs in connection with the installation or production of a replacement asset. These costs may be immediately expensed in the year incurred.

Qualified Leasehold Improvements (QLHI)

- Section 1250 (real property) leasehold improvements made to the interior portion of a commercial property by a lessor or lessee pursuant to a lease more than three years after the commercial property was placed in service.
- This applies to QLHI placed in service after 10/22/04 and before 1/1/12.
- Permits a 15 year recovery period, instead of the 39 year recovery period.
- The following are excluded from the definition of a QLHI:
 - The enlargement of a building
 - Elevators and escalators
 - Structural components that benefit a common area
 - Improvements to the internal structural framework of the building

Capital vs. Repair – The Opportunity

- The new regulations are generally taxpayer friendly
- Virtually every taxpayer can expense a significant amount of capitalized costs that qualify as deductible repairs under existing authority
- Most of the favorable rules in the proposed regulations are based on existing case law or published guidance -- taxpayers may adopt these methods before the regulations are finalized

Capital vs. Repair – Change in Landscape with Proposed Regs.

- Plan of Rehabilitation” eliminated
- More liberal view of repairs via proposed regulation examples:
 - Asbestos removal and replacement with similar insulation
 - Retail store “re-branding” and periodic layout construction (§1250 property)
 - Roof replacement (as long as not a “betterment”)
 - Turbine blade replacements within a steam turbine



Capital vs. Repair – Section 162

- Under Section 162, costs incurred for routine repair and maintenance may be deductible where the costs are:
 - Incidental,
 - Ordinary, and
 - Necessary business expenses



Capital vs. Repair – Factors

- In order to qualify costs as a repair, taxpayers must perform the following analysis:
 - Determine the Unit of Property
 - Analyze the costs using a Three-prong Test
 - Determine whether the expenditure is a part of an overall plan of rehabilitation



Capital vs. Repair – Unit of Property

- Factors courts have considered in determining unit of property:
 - Whether the taxpayer and the taxpayer's industry treats the component as part of a larger unit of property (e.g. engine);
 - Whether the economic useful life of a component part is coextensive with the economic useful life of a larger unit of property;
 - Whether the larger unit of property and smaller unit of property could function without one another; and,
 - Whether the component part could be maintained while attached to the larger unit of property.

Capital vs. Repair – Unit of Property Overview

- Functional interdependence test:
 - *Hawaiian Independent Refinery, Inc. v. U.S.*, 697 F.2d 1063 (Fed. Cir. 1983)
 - *Armstrong World Industries, Inc. & Affiliated Cos.*, 974 F.2d 422 (3rd Cir. 1992)
 - *Public Service Co. of New Mexico v. U.S.*, 431 F.2d 980 (10th Cir. 1970)
- *FedEx Corp. v. United States*—multiple tests

Capital vs. Repair – Three-Prong Test

- The courts and the IRS have developed a three-prong test to help distinguish capital vs. repair expenditures:
 - Does the expenditure adapt the property for a new or different use,
 - Does the expenditure materially add to the value of the property, or
 - Does the expenditure appreciably prolong the economic life of the property?

If the answer is “Yes” to any of these questions, the expenditure is more likely capital in nature.

Capital vs. Repair – Example I

- The owner of a retail store replaces displaced wooden shingles on a damaged roof with new shingles of a similar grade and quality.
- The taxpayer classifies the building as the UOP
- The expenditures do not:
 - Materially add value to the UOP (i.e., building);
 - Appreciably prolong the useful life of the building; or
 - Adapt the building to a new or different use
- For tax purposes, the expenditures are deductible repairs



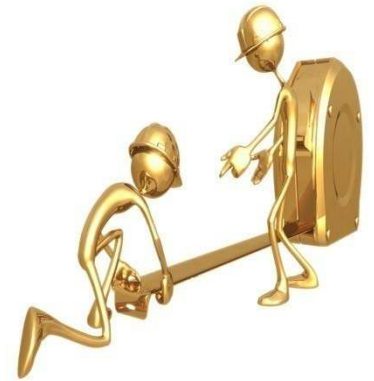
Capital vs. Repair – Example II

- The owner of a retail store replaces one-fourth of the shingles on a roof with new shingles of a similar grade and quality in each of four successive years in a plan to replace the entire roof.
- The taxpayer classifies the building as the UOP
- The expenditures do not:
 - Materially add value to the UOP (i.e., building);
 - Appreciably prolong the useful life of the building; or
 - Adapt the building to a new or different use
- For tax purposes, the expenditures are deductible repairs



Capital vs. Repair – Example III

- A company resurfaces an existing surface parking lot and expands its capacity by 20%.
- The taxpayer classifies the parking lot as the UOP
- The expenditures:
 - Materially add value to the UOP (i.e. parking lot); and
 - Appreciably prolong the useful life of the parking lot.
- For tax purposes, the expenditures should be capitalized and depreciated.



Capital vs. Repair – General Rule

- If improvements are made to “put” an asset in efficient operating condition, then the expenditures are generally capital in nature.
- If, however, the improvements were made to simply “keep” an asset in efficient operating condition, then they are generally repairs and are deductible.



Capital vs. Repair – Plan of Rehabilitation

- Generally, a taxpayer must capitalize the cost of repairs that are made as part of an overall plan of rehabilitation, modernization, and improvement, even if the cost would have been deductible if the repairs had been made without a plan.
- The courts have applied the rehabilitation doctrine in cases where substantial capital improvements and repairs to the same specific asset (usually a structure in a state of disrepair).

Capital vs. Repair – New Regulations

- Proposed tangibles (repairs) regulations under Sec. 263(a) first issued on August 21, 2006
- IRS digested comment letters filed by a number of industry groups for almost two years
- Instead of finalizing the regulations with changes, IRS reissued proposed regulations on March 10, 2008
- The proposed regulations provide that repairs that are made at the same time as an improvement, but that do not directly benefit or are not incurred by reason of the improvement, are not required to be capitalized under section 263(a).

Capital vs. Repair – Betterments

- In general, a taxpayer must capitalize amounts that result in the betterment of a unit of property. An amount results in a betterment only if it:
 - Ameliorates a material defect or condition that existed prior to the taxpayer's acquisition, or arose during the production, whether or not the taxpayer was aware of the condition.
 - Results in a material addition, such as a physical enlargement, expansion, or extension to the unit of property.
 - Results in a material increase in capacity, productivity, efficiency, strength, or quality of the unit of property or output of the unit of property.

Capital vs. Repair – Betterments

- To determine whether an amount paid results in a betterment, all the facts and circumstances must be considered, including:
 - Purpose of the expenditure
 - Physical nature of the work performed
 - Effect of the expenditure on the unit of property
 - Taxpayer's treatment of the expenditure on its applicable financial statement



Capital vs. Repair – Areas of Opportunity

- Normal repairs of buildings, parking lots and personal property
- Remodeling and renovation costs
- Moving costs
- Cost of reconfiguring space for marketing reasons
- Reimaging costs
- Replacing windows, tiles
- Some “soft” costs



Capital vs. Repair – Examples of Repair Items

- Roof repairs
- Parking lot repairs
- On-going maintenance projects
- HVAC system repairs
- Boiler repairs
- De minimis expenses
- Other building repairs (walls, floors, etc.)
- Removal costs
- Painting
- Certain upgrades and refurbishments





Repairs and Maintenance – Case Law

- Guidance in support of expense treatment
 - Appeal of Illinois Merchants Trust (1926)
 - Plainfield-Union Water v. Commissioner (1962)
 - Moss v. Commissioner (1987)
 - Ingram v. Commissioner (2000)
- Guidance in support of capitalization treatment
 - Bank of Houston v. Commissioner (1960)
 - Dominion Resources v. US (1999)
 - Rev. Rul. 2001-4
 - Vanalco v. Commissioner (2002)

IRS Audit

- Designated as Tier I issue on January 22, 2010
 - Considered “ripe for abuse” by IRS; focus is on substantiation and restraint
 - Signifies that “everyone else is doing it” based on volume of 3115s
- IRS Tier 1 Audit
 - Involves Issue Champions, Area Counsel and support, Industry Reps and Technical Advisors
 - IRS appears to be nationally following a playbook
 - Standard IDRs
 - Full disallowance/60% disallowance
 - Taxpayer settlement or go to appeals
- Field Audit Directives
 - Repairs Audit Technique Guide
 - IRS is now letting agents settle cases

QUESTIONS?



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See You Upstairs!

(Drinks, Appetizers & Prizes at Perkins & Co: 10th Floor)