Tangible property regulations—Additional guidance provided for taxpayers engaged in a trade or business in the retail or restaurant industry

IRS provides safe harbor method for remodel or refresh costs

Prepared by:

Ryan Corcoran, Manager, Washington National Tax, RSM US LLP
ryan.corcoran@rsmus.com, +1 202 370 8235

Kari Peterson, Senior Manager, Washington National Tax, RSM US LLP
kari.peterson@rsmus.com, +1 202 370 8241

Christian Wood, Principal, Washington National Tax, RSM US LLP
christian.wood@rsmus.com, +1 202 370 8218

February 2016

In November 2015, the IRS issued long-awaited guidance with regard to the tax treatment of remodel or refresh expenditures for taxpayers operating a trade or business in the retail or restaurant industry. Rev. Proc. 2015-56 (hereinafter called the Retail Guidance) provides qualified taxpayers a safe harbor method of accounting for determining whether expenditures paid or

incurred to remodel or refresh a qualified building are deductible under section 162(a), must be capitalized as improvements under section 263(a) or must be capitalized as the costs of property produced by the taxpayer for use in its trade or business under section 263A.[1] Additionally, the Retail Guidance provides qualified taxpayers procedures to obtain automatic consent to change to the safe harbor method of accounting.

The Retail Guidance, which originated from the IRS' Industry Issue Resolution (IIR) program, was initiated to reduce disputes on the deductibility or capitalization of remodel or refresh costs. The objective of the IIR program is to identify frequently disputed or burdensome tax issues that are common to a significant number of business taxpayers that may be resolved through published or other administrative guidance, rather than a post-filing examination.[2] Taxpayers and trade groups involved with the retail and restaurant industries requested additional clarification and guidance with regard to the tangible property regulations, specifically the capitalization rules with regard to the application of the unit of property rules, refresh and remodel expenditures and rules for general maintenance and repair expenses.[3]

This article provides insight on the Retail Guidance, with a focus on the safe harbor method of accounting, who is a qualified taxpayer, qualified remodel or refresh expenditures and other criteria a taxpayer must meet to use the safe harbor method of accounting. This article references the final tangible property regulations, for which our previous four-part series can be found here (see "The final tangible property regulations" — Part I, Part II, Part III and Part IV).

Overview

The final tangible property regulations (the Regulations), issued in September 2013, provide taxpayers a facts-and-circumstances framework to assist taxpayers in determining whether an expenditure is a deductible business expense (i.e., a repair or maintenance-type cost under Reg. section 1.162-4) or an expenditure that is capitalized under section 263(a) as an improvement to the unit of property. When a taxpayer has improved tangible property it generally must capitalize the expenditure. The Regulations describe three facts and circumstances (the "improvement standards") to assist taxpayers when determining if the taxpayer has improved a unit of property:[4]

1. Is the amount paid a betterment to the unit of property?
2. Does the amount paid restore the unit of property?
3. Does the amount paid adapt the unit of property to a new or different use?

The Regulations also provide several detailed examples in which the improvement standards are applied to various expenditures; however, the examples provided in the regulations do not approach the level of complexity in analyzing and applying the improvement standards to the work performed in remodel or refresh projects.

Additionally, direct and allocable indirect costs of real or tangible property produced by a taxpayer must be capitalized under section 263A.[5] Prior to the Retail Guidance, a qualified taxpayer undertaking a remodel or refresh project would not only have to apply a factual analysis to each building structure and structural component, but may also have to perform an analysis under section 263A, as costs to produce property.

In light of the complexity of the analysis and the administrative time required by both taxpayers and the IRS in resolving a dispute during examination, the IRS issued the Retail Guidance, which provides taxpayers criteria to determine what remodel or refresh project costs qualify for the safe

1 Rev. Proc. 2015-56, 2015-49 IRB.

2 Rev. Proc. 2003-36, 2002-1 C.B. 993.

3 IRS.gov — "IRS and Treasury Select Key Retailers Tax Issue for Industry Issue Resolution Program", last accessed Dec. 4, 2015, https://www.irs.gov/Businesses/Corporations/IRS-and-Treasury-Select-Key-Retailers-Tax-Issue-for-Industry-Issue-Resolution-Program. IR-2014-118, "IRS and Treasury Select an Issue for Industry Issue Resolution Program", Dec. 23, 2014, https://www.irs.gov/uac/Newsroom/IRS-and-Treasury-Select-an-Issue-for-Industry-Issue-Resolution-Program-2014.

4 Reg. section 1.263(a)-3.

5 Section 263A(a)(2).

harbor, what allocation of project costs the taxpayer can expense and capitalize, the depreciation guidelines of such capitalized amounts, the depreciable life under section 168(e) and what, if any, dispositions and partial dispositions the taxpayer can make under the safe harbor. Additionally, the safe harbor provides taxpayers procedures for adopting the safe harbor, revoking a partial disposition election and making a late general asset account election.

The remodel or refresh safe harbor provided in the Retail Guidance allows a qualified taxpayer to treat 75 percent of its qualified remodel or refresh costs paid during the taxable year as amounts deductible as ordinary and necessary business expenses and then treat the remaining 25 percent of its qualified costs paid during the taxable year as costs for improvements to a qualified building and as costs paid for the production of property for use in the qualified taxpayer's trade or business.[6]

The 75 percent of costs that a taxpayer may deduct is not deductible until the remodel or refresh project is placed in service. The 25 percent of costs required to be capitalized are to be treated as a separate asset for depreciation purposes and depreciated under sections 167 and 168 when the capital expenditure is placed in service. For capitalization classification purposes, a taxpayer may use the shorter depreciable life, to the extent it can substantiate the capital expenditure portion as qualified leasehold improvement property, qualified restaurant property or qualified retail improvement property, as applicable. If a taxpayer cannot substantiate the capitalized expenditure portion as such, then the expenditure is nonresidential real property. Additionally, a taxpayer must include the capitalized costs in a general asset account under section 168(i)(4) and Reg. section 1.168(i)-1.

Qualified taxpayer	Treatment of qualified costs	Treatment of excluded costs
Taxpayer engaged in operating trade or business in the retail or restaurant industry (see below for specific criteria)	75 percent of qualified costs deductible as ordinary and necessary business expenses; remaining 25 percent capitalized as improvements to qualified building and as costs for the production of property Costs treated as paid or incurred when the capitalized portion is placed in service Adequate documentation required for qualified costs Taxpayer required to make general asset account election for capitalized improvement costs, existing qualified buildings and prior years' improvements to a qualified building that are modified accelerated cost recovery system (MACRS) property Taxpayer precluded from utilizing the routine maintenance safe harbor for any qualified costs	Taxpayer must perform improvement standard analysis to determine if expenditure is improvement or repair and maintenance activity Taxpayer must perform analysis to determine if any costs are required to be capitalized as costs for the production of property Taxpayer can utilize the safe harbor for routine maintenance for excluded costs

6 Rev. Proc. 2015-56, 2015-49 IRB.

Criteria to use the safe harbor

In order to use the safe harbor method, a taxpayer must first be engaged in the trade or business of operating or selling merchandise to customers at retail; the trade or business of preparing and selling meals, snacks or beverages to customer order for immediate on-premises or off-premises consumption; or owning, or leasing, a qualified building to a taxpayer that meets one of the previous two criteria.

Qualified taxpayer	Criteria to use safe habor	Excluded from using safe habor
Retail	Taxpayer, with an applicable financial statement (AFS), that reports or conducts activities within NAICS code 44 or 45, except for (see next column) Building unit of property primarily used for selling merchandise to customers at retail. Selling merchandise criteria includes sales to resellers if product is sold to resellers in same manner as nonreseller (e.g., warehouse clubs or home improvement stores)	Taxpayer that primarily reports or conducts activities within the following NAICS codes: Code 4411 (automotive dealers) Code 4412 (other motor vehicle dealers) Code 447 (gas stations) Code 45393 (manufactured home dealers) Code 454 (nonstore retailers)
Restaurant	Taxpayer, with an AFS, that reports or conducts activity within NAICS code 722, except for (see next column) Building unit of property primarily used for preparing and selling food or beverages to customer order for immediate on-premises or off-premises consumption	Taxpayer that is primarily in the trade or business of: operating hotels and motels; civic or social organizations; or amusement parks, theaters, casinos, country clubs or similar recreational facilities Taxpayer that primarily reports or conducts activities within code 7223 (special food services; i.e., food service contractors, caterers and mobile food services)

The Retail Guidance defines a remodel or refresh project as a "planned undertaking by a qualified taxpayer on a qualified building to alter its physical appearance and/or layout for one or more of the following purposes:

(a) To maintain a contemporary and attractive appearance;

(b) To more efficiently locate retail or restaurant functions and products;

(c) To conform to current retail or restaurant building standards and practices;

(d) To standardize the consumer experience if a qualified taxpayer operates more than one qualified building;

(e) To offer the most relevant and popular goods within the industry; or

(f) To address changes in demographics by changing product or service offerings and their presentations."

A review of the criteria for a remodel or refresh project demonstrates the complexity in determining whether taxpayers must capitalize expenditures using the improvement standards. For instance, prior to the Retail Guidance, most of the qualified activities listed in the chart above would require an improvement standard analysis for both a building structure and specified building systems (as defined in Reg. section 1.263(a)-3(e)(2)). However, as the safe harbor method applies to the entire qualified building unit, the taxpayer does not need to separately perform an analysis on the building structure or specified building system. Additionally, the safe harbor does not require a taxpayer to capitalize the entire project to adapt a portion of a space to a new and different use (i.e., relocating or changing the square footage of certain departments, checkout areas, storage spaces and dressing rooms within the footprint of the existing building), as long as the adaptation does not adapt more than 20 percent of the total square footage of the building to a new or different use.

Qualified and excluded activities

The Retail Guidance provides 18 examples of remodel, refresh, repair, maintenance or similar activities that the IRS determined to be qualified activities. It should be noted that an item excluded from this list does not mean it is not a qualified activity; however, the Retail Guidance does provide items which are explicitly excluded costs.

Qualified remodel or refresh activities	Excluded costs
1. Painting, polishing or finishing interior walls	1. Section 1245 property
2. Adding, replacing, repairing, maintaining or relocating permanent floor, ceiling or wall coverings, including millwork	2. An intangible under Reg. section 1.263(a)-4(b), including the creation or maintenance of computer software
3. Adding, replacing, repairing, maintaining or relocating kitchen fixtures	3. Land, including nondepreciable land improvements, or depreciable land improvements described in Asset Class 00.3 of Rev. Proc. 87-56
4. Adding, replacing or modifying signage or fixtures	4. The initial acquisition, production or lease of a qualified building, including purchase price, construction costs, transaction costs and the costs of work performed prior to the date that the qualified building is initially placed in service by the qualified taxpayer
5. Relocating departments, eating areas, checkout areas, kitchen areas, beverage areas, management space, storage space or similar areas, within the existing footprint of the qualified building	5. The initial build-out of a leased qualified building, or a portion thereof, for a new lessee
6. Increasing or decreasing the square footage of departments, eating areas, checkout areas, kitchen areas, beverage areas, management space, storage space or similar areas within the existing footprint of the qualified building	6. Activities to rebrand a qualified building performed within two taxable years following the closing date of: (1) an acquisition or initial lease of the qualified building by the qualified taxpayer or a person related to the qualified taxpayer, or (2) the acquisition by the qualified taxpayer or a person related to the qualified taxpayer of a controlling interest in the qualified building or in a lease or the qualified building
7. Adding, relocating or removing a room or rooms (e.g., dressing rooms, "private" dining space, front office space or break rooms) within the existing footprint of the qualified building	
8. Moving, constructing or altering walls within the existing footprint of the qualified building	

Continued from page 5.

Qualified remodel or refresh activities	Excluded costs
9. Adding, relocating, removing, replacing or relamping lighting fixtures or adding reflectors, mirrors or other similar devices to existing light fixtures	7. Activities performed to ameliorate a material condition or defect that existed prior to the qualified taxpayer's acquisition or lease of the qualified building or that arose during the production of the qualified building, regardless of whether the qualified taxpayer was aware of the condition or defect at the time of acquisition or production
10. Repairing, maintaining, retrofitting, relocating, adding or replacing building systems within the existing footprint of the qualified building	8. Material additions to a qualified building, including the building systems. For purposes of these excluded costs only, additions mean enlarging, expanding or extending the square footage of the qualified building or enlarging, expanding or extending the building systems in conjunction with enlarging, expanding or extending the square footage of the qualified building
11. Making nonstructural changes to exterior facades	9. Restoration caused by damage to the qualified building for which the qualified taxpayer is required to take a basis adjustment as a result of a casualty loss under section 165 or relating to a casualty event described in section 165
12. Relocating, replacing or adding windows or doors (including replacing a manual door with an automatic door) within the existing footprint of the qualified building	10. Adapting more than 20 percent of the total square footage of a qualified building to new or different use or uses
13. Repairing, maintaining or replacing the roof or portion of the roof within the existing footprint of the qualified building	11. Remodel or refresh costs incurred during a temporary closing, defined as closing the qualified building during normal business hours for more than 21 consecutive calendar days
14. Replacing façade materials around windows and entrances	12. The cost of any property for which the qualified taxpayer has claimed a deduction under section 179, section 179D or section 190
15. Repair and maintenance to the qualified building that directly benefits or is incurred by reason of a remodel or refresh project	13. Expenditures treated as qualified lessee construction allowances under section 110
16. Removal and demolition of structural components of a qualified building that directly benefit or are incurred by reason of a remodel or refresh project	
17. Obtaining permits or other similar authorizations that directly benefit or are incurred by reason of a remodel–refresh project	
18. Architectural, engineering and similar services that directly benefit or are incurred by reason of a remodel or refresh project	

Dispositions

Under the safe harbor, a taxpayer cannot recognize a disposition or make a partial disposition for any original qualified building (or partial), any prior improvement (or partial) or prior addition (or partial) to an original qualified building. The rationale for the disallowance of the dispositions and the partial disposition election is that the safe harbor already takes into account losses on dispositions of qualified building assets.

Generally, a disposition or partial disposition election is made on a taxpayer's timely filed (including extensions) original return for the taxable year in which the portion of an asset is disposed.[7] However, as part of the Regulations, a taxpayer could make a late partial disposition election by filing Form 3115 for taxable years beginning on or after Jan. 1, 2012, and before Jan. 1, 2015. Many taxpayers took advantage of these provisions to deduct previously abandoned structural components. Due to the potential for the safe harbor to exclude taxpayers that recognized a disposition or made a partial disposition election, the Retail Guidance requires taxpayers to revoke any dispositions (or partial) prior to adopting the Retail Guidance for the first taxable year in which the qualified taxpayer uses the safe harbor. This means that if a taxpayer desires to retroactively apply the safe harbor to a qualified building to which the taxpayer previously made a partial disposition election, the taxpayer must change the treatment of dispositions (or partial) on a qualified building through an accounting method change for the first or second taxable year beginning after Dec. 31, 2013. A calendar year taxpayer must file the change in accounting method with its 2015 tax return, which is due on March 15, 2016, or Sept. 15, 2016, for a corporate taxpayer. Failure to file the accounting method change by then would preclude application of the safe harbor to prior years, and the taxpayer would apply the change on a cutoff basis with respect to the qualified building for which it did not revoke the partial disposition election.

In order to avoid recognizing dispositions on a prospective basis, a taxpayer must place its qualified building property (and prior improvements or additions, if it needs to apply the safe harbor retroactively) in their own general asset account. When an asset is placed in a general asset account, taxpayers do not recognize a gain or loss on disposition of an asset. To the extent that a taxpayer makes a late general asset account election and applies the Retail Guidance retroactively, the section 481(a) adjustment must be recognized in full in the year of change.

Once the taxpayer is beyond the second taxable beginning after Dec. 31, 2013, the taxpayer can only revoke a partial disposition election under the regulations by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election.[8] As the method change for revoking a partial disposition provides that the change must be for the qualified taxpayer's first or second taxable year beginning after Dec. 31, 2013, there may be taxpayers with short tax years that are already ineligible to make this change.

General asset accounts

The Retail Guidance provides that in order for a taxpayer to use the safe harbor method of accounting, the taxpayer must make a general asset account (GAA) election, under section 168(i)(4) and Reg. section 1.168(i)-1(l) and place the following into GAAs:

(1) The capital expenditure portion;
(2) Existing qualified buildings (including their structural components) that are MACRS property;
(3) Prior years' improvements that are MACRS property and made to a qualified building (even if the qualified building is not MACRS property).

For an in-depth discussion on general asset accounts, see The final tangible property regulations — Part IV.

7 Reg. section 1.168(i)-8(d)(2).

8 Reg. section 1.168(i)-8(d)(2).

For a taxpayer that has a qualified building, which has been placed in service prior to the first taxable year of the taxpayer utilizing the remodel or refresh safe harbor and the qualified building or any improvement or addition to an original qualified building have previous partial dispositions, the taxpayer can choose to apply the Retail Guidance retroactively (by revoking the partial disposition election on that otherwise qualified building) or prospectively by not revoking the partial disposition on that qualified building. If the taxpayer must apply the Retail Guidance retroactively (whether by revoking the partial disposition election, or by the fact there are no partial dispositions to revoke), a late general asset account election generally must be made with respect to the MACRS property of a qualified building on the taxpayer's original federal tax return for the first taxable year the taxpayer uses the remodel or refresh safe harbor. In the year adopting the safe harbor, the taxpayer can treat a late GAA election as a change in method of accounting, and by making the late election, the taxpayer agrees to apply all of the GAA provisions, under Reg. section 1.168(i)-1, to the assets included in that GAA.

The Retail Guidance provides special rules, which closely mirror the special rules found in Reg. section 1.168(i)-1(e), for the building unit of property and its structural components. In applying this Retail Guidance, the building unit of property is each qualified building and its structural components. For a condominium with multiple units, each individual unit and its structural components are the unit of property. For an interest in a cooperative housing corporation, each portion of the qualified taxpayer's possessory rights and the related structural components are the unit of property. If a qualified taxpayer leases an entire building, the building and the structural components subject to the lease are the unit of property. If the lease to a qualified taxpayer is for only a portion of a building, the portion of the building and its associated structural components are the unit of property.

When a taxpayer places an asset in a GAA, it does not recognize gain or loss on a disposition of an asset; instead the taxpayer simply continues to depreciate the asset as if the disposition had never occurred. The taxpayer can only terminate a GAA on a qualifying disposition. Following the disposition rules under Reg. section 1.168(i)-1(e), for qualified building assets included in a general asset account, a cessation, termination or disposition of an entire qualified building is a qualifying disposition.[9] If a taxpayer disposes of an improvement included in the GAA as a result of the remodel or refresh project, that disposition is not a qualifying disposition.

Potential pitfall

Also, there may be an issue if the taxpayer has elected to capitalize repair and maintenance costs, under Reg. section 1.263(a)-3(n). Under that election, a taxpayer may elect to treat amounts paid during the taxable year for repair and maintenance (as defined under section 1.162-4) to tangible property as amounts paid to improve that property, under this section, and as an asset subject to the allowance for depreciation if the taxpayer incurs these amounts in carrying on the taxpayer's trade or business and if the taxpayer treats these amounts as capital expenditures on its books and records regularly used in computing income. A taxpayer that elects to apply this Reg. section 1.263(a)-3(n) in a taxable year must apply this paragraph to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that taxable year. The election to capitalize repair and maintenance precludes the safe harbor, because it may create a difference between what a taxpayer capitalizes for financial statement purposes and the amount a taxpayer would capitalize under the safe harbor.

Implications

This guidance has been long-awaited by taxpayers and provides a safe harbor method to determine how to treat costs incurred for a remodel or refresh project. However, as the guidance was issued after the majority of taxpayers filed their 2014 income tax returns and adopted provisions of the tangible property regulations, taxpayers should review the prior changes in method of accounting requested to determine if a late partial disposition election, with regard to

9 Under Reg. section 1.168(i)-1(e), an asset in a general asset account is disposed of when ownership of the asset is transferred or when the asset is permanently withdrawn from use in the taxpayer's trade or business or in the production of income. A disposition includes the sale, exchange, retirement, physical abandonment or destruction of the asset. See also Section 5.02(5)(f) of Rev. Proc. 2015-56.

the qualified property, must be revoked. Additionally, taxpayers should review their prior year dispositions carefully to ensure no prior year components of a qualified building were disposed. To the extent that taxpayers are still operating under the temporary regulations, under Reg. sections 1.168(i)-1T or 1.168(i)-8T, there are special requirements to adopt the Regulations prior to adopting the safe harbor, or the taxpayer may lose the ability to retroactively apply the safe harbor.

Unless precluded from calculating a section 481(a) adjustment, a taxpayer adopting the safe harbor method must review its prior years' improvements, qualified buildings and prior remodel or refresh expenditures, and compute a section 481(a) adjustment with respect to these items. Taxpayers should be aware that the safe harbor method of accounting applies retroactively on a qualified building-by-building basis.

Since the adoption of the remodel or refresh method of accounting provides that a taxpayer must compute a section 481(a) adjustment with respect to prior years' expenditures, taxpayers should analyze each qualified building separately to determine whether the Retail Guidance must be applied on a retroactive or cut-off basis to that qualified building.

As each remodel or refresh project may have excluded costs, it is important that taxpayers review the excluded costs and determine the proper treatment of those costs, under the tangible property regulations (i.e., repairs, amounts paid to acquire and produce tangible property, costs to improve units of property, and capitalization and inclusion in inventory costs).[10]

10 Reg. sections 1.162-4, 1.263(a)-2, 1.263(a)-3 and section 263A, respectively.

+1 800 274 3978
www.rsmus.com

This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute audit, tax, consulting, business, financial, investment, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. RSM US LLP, its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person. Internal Revenue Service rules require us to inform you that this communication may be deemed a solicitation to provide tax services. This communication is being sent to individuals who have subscribed to receive it or who we believe would have an interest in the topics discussed.

RSM US LLP is a limited liability partnership and the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. The member firms of RSM International collaborate to provide services to global clients, but are separate and distinct legal entities that cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party. Visit rsmus.com/aboutus for more information regarding RSM US LLP and RSM International.

RSM® and the RSM logo are registered trademarks of RSM International Association. *The power of being understood®* is a registered trademark of RSM US LLP.

© 2016 RSM US LLP. All Rights Reserved.

tl_nt_tax_all_0416