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IRS Issues Favorable Rules For Retail Remodeling Costs

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On Nov. 19, the IRS released Revenue Procedure 2015-56, which provides a safe harbor method of accounting for costs incurred by retailers and restaurants in remodel and refresh projects. In general, the safe harbor allows taxpayers to deduct 75 percent of such costs under section 162 and capitalize the remaining 25 percent under section 263(a).

The rules are the culmination of a multiyear effort by the retail and restaurant industries to obtain clarity for frequently incurred remodel and refresh costs. The rules may be applied retroactively for taxable years beginning on or after Jan. 1, 2014.

Background — The Tax Stakes

Deduction vs. Capitalization. Under section 162, taxpayers may deduct amounts paid for repair and maintenance of tangible property unless the amounts are otherwise required to be capitalized under section 263(a).

Under Reg. § 1.263(a)-3 (commonly known as the "repair regulations"), taxpayers must capitalize amounts paid to improve a unit of property. For this purpose, the repair regulations define an improvement as the betterment or restoration of a unit of property or the adaptation of a unit of property to a new or different use. The repair regulations treat the building structure (i.e., walls, partitions, floors and ceilings) as a separate unit of property from each of the building's systems (e.g., HVAC, plumbing and electrical).

Refresh vs. Remodel Costs Under the Repair Regulations. The repair regulations permit the deduction of costs to "refresh" property, but require the capitalization of remodeling costs.

For instance, Reg. 1.263(a)-3(j)(3), Example 6, provides that "refresh" costs are generally deductible. In that example, the taxpayer owns a chain of retail stores. To maintain the appearance and functionality of its stores, the taxpayer periodically pays amounts to "refresh" the look and layout of its stores. The work consists of cosmetic and layout changes to the store's interiors and general repairs and maintenance to the store building, including relocating lighting, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure, replacing damaged ceiling tiles, cleaning and repairing flooring throughout the store building and power washing building exteriors.

Example 6 concludes that all of the costs of the refresh are deductible as repairs that keep the store buildings' structures and systems in their ordinarily efficient operating condition.

By contrast, Reg. 1.263(a)-3(j)(3), Example 8, provides that more extensive "remodel" costs must be capitalized. In that example, the taxpayer owns a chain of retail stores. In response to changes in the retail market, the taxpayer decides to upgrade its stores to offer higher end products to a different type of customer. To offer these products and attract different types of customers, the taxpayer must substantially remodel its stores. It replaces large parts of the exterior walls with windows, replaces escalators with a monumental staircase, adds a new glass enclosed elevator, rebuilds the interior and exterior facades, replaces vinyl floors with ceramic flooring, replaces ceiling tiles with acoustical tiles and removes and rebuilds walls to move changing rooms and create specialty departments. The work also includes upgrades to increase the capacity of the buildings' electrical systems to accommodate the structural changes. The work to the electrical system also involves the installation of new more efficient and mood enhancing lighting fixtures. In addition, the work includes remodeling all bathrooms by replacing contractor-grade plumbing fixtures with designer-grade fixtures that conserve water and energy.

Example 8 concludes that all of the costs of the remodel are improvements to the buildings' structures and systems that must be capitalized.

Need for Additional Guidance. It can be difficult for retailers and restaurants to distinguish between deductible refresh costs and capitalizable remodeling costs as set forth in the repair regulations. For that reason, following the finalization of the regulations in September 2013, the retail and restaurant industries sought additional guidance from the IRS, ultimately resulting in the safe harbor method set forth in Revenue Procedure 2015-56. As described below, the new safe harbor makes it unnecessary for retailers and restaurants to draw lines between refresh and remodel costs.

Who May Use the Safe Harbor?

The safe harbor method only applies to "qualified taxpayers," defined as (1) retailers, (2) restaurants or (3) owners (or lessees) of a building that lease (or sublease) the building to a retailer or restaurant, and that in each case that file an "applicable financial statement." An applicable financial statement is (1) a financial statement filed with the U.S. Securities and Exchange Commission; (2) an independently audited financial statement that is used for reporting to shareholders or creditors or for any substantial nontax purpose; or (3) a financial statement (other than a tax return) required to be provided to a governmental entity other than the SEC or the IRS. The applicable financial statement requirement will prevent many small retailers and restaurants from being able to apply the safe harbor.

What are Remodel and Refresh Costs?

Remodel and refresh costs are amounts paid by a qualified taxpayer for remodel, refresh, repair, maintenance or similar activities performed on a building that is used by the taxpayer primarily for selling merchandise to customers at retail or for preparing and selling food or beverages ordered by customers for immediate consumption (a "qualified building") to alter the building's physical appearance and/or layout.

Examples of remodel and refresh costs that are eligible for the safe harbor ("qualified costs") include:

- Painting, polishing or finishing interior walls;
- Adding, replacing, repairing, maintaining or relocating floor, ceiling or wall coverings, or kitchen fixtures;
- Adding, replacing or modifying signage or fixtures;
- Relocating, adding, removing or reconfiguring the square footage of departments, eating areas, checkout areas, kitchen areas, beverage areas, management space, storage space or other rooms, within the existing footprint of the qualified building;
- Moving, constructing or altering walls within the existing footprint of the qualified building;
- Adding, relocating, removing or replacing lighting fixtures;
- Repairing, maintaining, retrofitting, relocating, adding or replacing building systems within the existing footprint of the qualified building;
- Making nonstructural changes to exterior facades;
- Relocating, replacing or adding windows or doors within the existing footprint of the qualified building;
- Repairing, maintaining or replacing the roof; and
- Permitting, architectural and engineering costs of a remodel-refresh project.

What Costs are not Eligible?

Certain costs are specifically excluded from the definition of remodel and refresh, including:

- Section 1245 property (e.g., display tables and racks);
- Intangible property (e.g., computer software);
- Land and improvements such as sidewalks, parking lots and landscaping;
- Initial acquisition, production or lease of a qualified building;
- Initial build-out of a leased qualified building for a new lessee;
- Ameliorating a material condition or defect that existed prior to the qualified taxpayer's acquisition or lease of the qualified building;
- Enlarging, expanding or extending the square footage of the qualified building;
- Restoring a casualty loss; and
- Adapting more than 20 percent of the total square footage of a qualified building to a new or different use as part of a remodel-refresh project.

Somewhat arbitrarily, the revenue procedure excludes remodel-refresh costs incurred during a temporary closing (i.e., closing the qualified building during normal business hours for more than 21 consecutive calendar days).

How is the Safe Harbor Method Applied?

In General. A taxpayer relying on the safe harbor must treat 75 percent of its qualified costs paid during the taxable year as deductible under section 162(a) and treat the remaining 25 percent of its qualified costs as costs for improvements to a qualified building under section 263(a) ("the capital expenditure portion").

Treatment of the Capital Expenditure Portion. The capital expenditure portion is treated as a separate

asset subject to depreciation under sections 167 and 168. To the extent the costs satisfy the requirements for qualified leasehold improvement property, qualified restaurant property or as qualified retail improvement property (as defined in sections 168(e)(6), (7) and (8), respectively), the capital expenditure portion may be depreciated on a straight-line basis over 15 years. Any other amounts included capital expenditure portion are classified as nonresidential real property under section 168(e)(2)(B) and may be depreciated over 39 years.

Example 1. Taxpayer (T) operates a chain of retail stores. To maintain a contemporary and attractive environment, T alters the physical appearance and layout of its store buildings. Each project includes relocating or changing the square footage of certain departments, checkout areas, storage spaces and dressing rooms within the footprint of the existing buildings; removing, constructing and altering walls within the footprint of the existing buildings; moving lighting and replacing lighting fixtures with more efficient lighting; replacing bathroom fixtures with more updated and efficient fixtures; replacing or reconfiguring display tables and racks; patching and repainting interior walls and exterior structures; and replacing floor tiles, ceiling tiles and signage. These projects also include changes to the electrical, HVAC and plumbing systems within the buildings' existing footprints to accommodate the structural changes, new product offerings and bathroom upgrades. T's retail stores remain open to customers during the project, although parts of the store buildings are closed at different times during the process. In 2015, T pays $3 million for these activities to be performed on one of its qualified buildings (Building A). Of the $3 million, T pays $1 million for new display tables and racks, information kiosks, checkout counters and other equipment, all of which is section 1245 property. For 2015, T files a change in method of accounting to use the remodel-refresh safe harbor.

T's $3 million project is a remodel-refresh project as described in the safe harbor. Of the $3 million remodel-refresh costs, $1 million was paid for section 1245 property, which is excluded from qualified remodel-refresh costs. T may apply the remodel-refresh safe harbor method to the remaining $2 million, of which (1) 75 percent ($1,500,000) is deductible under section 162 and (2) the remaining 25 percent ($500,000) must be capitalized under section 263(a).

General Asset Account Requirement

One complicating feature of the remodel-refresh safe harbor is that a taxpayer that elects to apply the safe harbor must include the capital expenditure portion in a general asset account under section 168(i)(4) that includes the entire existing qualified building. In general, a taxpayer does not realize a loss upon disposition of the asset, or a portion of an asset, included in a general asset account; instead, the taxpayer must continue to depreciate the disposed asset.

Furthermore, taxpayers may not make a partial disposition election under Reg. § 1.168(i)-8(d)(2) with respect to the general asset account, including for any asset placed in service in a year before the taxpayer initially elects the safe harbor.

Example 2. The facts are the same as in Example 1. Because the entirety of Building A is in a general asset account, T would continue to depreciate the amounts allocable to the portions of the building and its electrical, HVAC and plumbing systems removed as part of the 2015 project.

Example 3. The facts are the same as in Example 1. Assume that in 2016, T experiences climate control problems in Building A and replaces one of the building's roof mounted HVAC units that was installed in 2010 and was not altered in the 2015 project. Because the replacement of HVAC unit does not to alter the physical appearance or layout of Building A, the amounts paid for the HVAC unit replacement are not remodel-refresh costs and must be analyzed separately under sections 162, 263 and 263A. In

addition, because Building A and its structural components are in a single general asset account, T would continue to depreciate the remaining adjusted basis of the HVAC unit replaced.

Another complicating feature of the remodel-refresh safe harbor is that a taxpayer that previously made a partial disposition election for any portion of an original qualified building must revoke that partial disposition election. As a consequence, if the taxpayer previously recognized a gain or loss upon the disposition of a component of a qualified building, the taxpayer must either (1) file amended returns for the year in which the partial disposition occurred and any subsequent years, adjusting the taxable income in in year for the revocation of the election, or (2) take into account the entire net amount as a section 481(a) adjustment in the year it elects to apply the safe harbor. Similar rules apply if the taxpayer recognized a gain or loss on the disposition of a component of a qualified building under Reg. §1.168(i)-1T or Reg. §1.168(i)-8 for years before 2012.

Example 4. The facts are the same as in Example 1. Assume that in 2014, T recognized a loss upon the replacement of the roof of Building A as a partial disposition. In order to apply the refresh-remodel safe harbor to its 2015 costs, T must revoke its partial disposition election and include in its taxable income the amount of the loss, less any depreciation that would have been allowed with respect to the roof since its replacement.

Election Mechanics

Taxpayers may generally use the automatic consent procedures of Rev. Proc. 2015-15 in order change their method of accounting to use the remodel-refresh safe harbor method by filing the relevant Forms 3115. Importantly, if the taxpayer is revoking a prior partial disposition election, the election to change to the remodel-refresh safe harbor must be made for the taxpayer's first or second taxable year beginning after Dec. 21, 2013.

Conclusion

The remodel-refresh safe harbor should be welcome news to most retailers and restaurants. While the method contains elements of rough justice, it will substantially reduce the need to allocate frequently-incurred costs between two often indistinguishable buckets. We would expect that many retailers and restaurants will adopt the safe harbor.

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