



# Real Estate Report

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## Expensing Your Company's New Roof: An IRS Paradigm is Turned on Its Head

By: John McGovern, Tax Supervisor

"Substantial roof repairs are always capitalized" has been an accepted IRS position for decades. However, recent court cases have forced the IRS to rethink their position on whether expenses incurred for maintaining fixed assets should be deductible as repairs or must be capitalized as improvements. As a result, proposed Treasury Regulations, issued in 2008, now provide guidance on distinguishing between expensing vs. capitalizing roofing expenditures.

The IRS provides a three part test for capitalizing roofs. If one fails all three tests, you may be able to deduct the cost in full during the current year.

1. The Betterment Test (does it make the building "better")
2. The Restoration Test (does it extend the useful life of the building)
3. The Adaptation Test (is it now suited for additional uses)

Some specific examples given:

- The examples refer to roofs in need of substantial repairs due to rotting and/or leaking. One can assume that no one would replace a functioning roof unless it met one of the conditions of the three part test.
- The betterment test is not met simply by replacing older shingles with modern replacements of superior quality. Wood shingles can be replaced

with composite shingles, but 20 year composite shingles cannot be replaced with 50 year, maintenance-free shingles that do not absorb water.

- Roofs that comprise over 50% of the buildings value must be capitalized.
- New roofs with significantly improved energy insulation characteristics must be capitalized. Just using lighter colored shingles to reduce heat does not meet the betterment test.

Replacements relating to casualty losses, tax loss transactions, or building purchases generally must be capitalized.

Additionally, roof repairs and or new roof expenditures incurred during the process of rehabilitation of a building will generally be capitalized.

In summary, to expense your new roof used in a trade or business:

1. Document the need for replacement. One leak in an otherwise healthy roof may not be enough.
2. Determine that your total roofing cost is less than 50% of total building value.
3. Replace your roof with similar, though updated and modernized, roofing material.
4. Test using the three part capitalization test. Your new roof must fail all three tests.

5. Form 3115, Application for Change in Accounting Method, provides recourse for previously capitalized roofs.

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## Carried Interest Legislation Tabled

By: Tom Cox, Tax Supervisor

**Q:** Recently, the Senate tabled legislation which would have taxed a "carried interest" as ordinary income. What is a carried interest?

**A:** A carried interest is best explained by providing an example. A private equity fund, in the form of a partnership compensates the general partner with a future profits only interest. Under current law, the profits only interest is deferred or "carried" and not taxed until the limited partners receive a return on their investment. When received, the deferred interest is taxed on the character of the allocated partnership income, generally long term capital gains, which are not subject to ordinary income or self employment tax. The carried interest legislation would have taxed a portion of the general partner's carried interest as ordinary income. The legislation would have also extended the rules to carried interest held by partners in real estate partnerships.



## How does Cost Segregation Affect Your Ability to Expense Repairs Under the Proposed Regulations?

By: Brenda Jemmott, Tax Manager

In the article *Expensing Your Company's New Roof: An IRS Paradigm is Turned on Its Head*, John McGovern discussed the IRS proposed regulations covering improvements to real property. We learned from that article that the regulations were largely a result of case law, specifically the 2003 FedEx Court Case. The proposed regulations adopt the common law concept of unit of property. Identification of a unit of property is critical in determining whether an expenditure must be capitalized or expensed. The proposed regulations set forth guidelines to determine the appropriate unit of property. We must then consider how cost segregation affects that determination and how do the two concepts co-exist?

The proposed regulations established that an entire building and its structural components are a single unit of property. Cost segregation categorizes different costs of the building into different class lives. Where there has been a cost segregation study, a portion of the building will be treated as personal property and depreciated over five or seven years and a portion of the building may be treated as qualified improvements and depreciated over 15 years. The remainder will have a class life of 39 years. Recategorizing the costs into the various class lives, 5, 7, 15 and 39 (27.5 if residential rental) years creates additional units. When a cost segregation is performed on a building, each class life creates an additional unit, instead of one unit there will likely be 4 units.

This distinction is important because it will affect the owner's ability to expense certain costs under the proposed regulations. If we take the example of a repair or replacement of the building's HVAC system, the ramifications of a cost segregation come to light. If there is no cost segregation on the building, then the building itself is the unit. If the HVAC system is then replaced, and the replacement does not substantially improve the value of the building or extend the life of the building, the costs could be expensed. However, if

a cost segregation study was performed on this same building, and the cost of the HVAC system was assigned a 5 year class life and treated as a separate unit, then the cost of the new HVAC system would have to be capitalized. In this case the remaining undepreciated balance of the old system could be expensed.

If a client is going back to assets previously placed in service and having a cost segregation study performed, a change in accounting method is required. If a change in accounting method is prepared to reflect the change in asset lives based on a cost segregation study, then the taxpayer cannot do another change in accounting method on the same or similar assets for 5 years. Therefore the tax advisor and client should consider the proposed regulations before doing the change in accounting method for cost segregation. This change would likely bar them from making a change to expense repairs and replacements per the proposed regulations. The client would have to wait 5 years to make the additional change.

To conclude, as part of the analysis in determining whether a cost segregation study is beneficial, the tax advisor and client should consider how a cost segregation study will affect the client's ability to expense repairs and replacements under the proposed regulations.



## Ask the CPA

By: Ray Evans  
Tax Manager

**Q:** I own a building that has unreinforced masonry bearing walls and will be making earthquake safety improvements. Will the improvements cause an increase in my property taxes?

**A:** New construction generally causes a reassessment if it adds a building, adds space, converts a building to a new use, or renovates the building to make it like new. In contrast, the assessed value is not increased for normal maintenance and repair, such as replacing a leaking roof.

Under California law, owners of unreinforced masonry buildings are subject to a property tax reassessment 15 years after they make seismic upgrades. Seismic retrofitting improvements to other types of structures are not subject to property tax reassessment.

On June 8, 2010, voters approved an amendment to the state Constitution allowing property owners to seismically retrofit any structure without property taxes being reassessed.

Call your accountant or a RINA real estate expert before making building improvements.



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