Remodeling? Refreshing?

You may be able to deduct costs through a safe harbor.

BY JULIE EISENHAUER

IF YOUR ESTABLISHMENT is among those planning or undertaking a remodel or refresh, I have some good news for you. The IRS recently issued a revenue procedure that provides a safe harbor method of accounting for certain expenditures incurred in remodeling or refreshing of restaurant and retail establishments.

The safe harbor clarifies which costs may be deducted immediately and which must be capitalized and depreciated over time. It reduces the need to perform a detailed factual analysis to determine if a cost is a repair or an improvement.

Who qualifies?

1. The taxpayer is in the business of selling merchandise to customers at retail or is in the business of preparing and selling meals to customers for consumption. Exceptions: There are specific exceptions, including gas stations, mobile food services and those primarily in the business of operating hotels, country clubs or similar recreation facilities.

2. The taxpayer has an Applicable Financial Statement (AFS), which is defined as:

- A financial statement filed with the Securities and Exchange Commission
- A certified audited financial statement
- A financial statement required to be provided to the federal or state government or agency (other than the SEC or IRS)

3. The taxpayer owns or leases a building used primarily for selling merchandise at retail or preparing and selling meals to customers for consumption.

What is a remodel or refresh project?

A remodel or refresh is 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:

- To maintain a contemporary and attractive appearance
- To more efficiently locate retail or restaurant functions and products
- To conform to current retail or restaurant building standards and practices
- To standardize the consumer experience if a taxpayer operates more than one qualified building
- To offer the most relevant and popular goods within the industry
- To address changes in demographics by changing product or service offerings and their presentations

A remodel or refresh project does not include a planned undertaking to repaint or to clean the interior or exterior of an existing building, which would likely be expensed in full as repair and maintenance costs. Examples of other excluded remodel or refresh costs include furniture and equipment, intangibles, land and land improvements, and initial build-out costs of a leased building.

How do you account for the qualified costs under the safe harbor?

The taxpayer must treat 75 percent of the qualified remodel or refresh project costs as deductible during the taxable year (the "deduction portion") and must treat the remaining 25 percent of costs paid during the taxable year as costs for improvements to a building (the "capital expenditure portion").

The "deduction portion" of the remodel and refresh costs paid are deducted in the taxable year when the "capital expenditure portion" is placed in service. The capital expenditure portion is depreciated over time, beginning on the date it is placed in service.

For example: A taxpayer who qualifies under the safe harbor definition and operates a retail establishment undertakes a planned remodel and refresh project under one of the stated conditions. The taxpayer pays $3 million for these activities. Of the $3 million, $1 million is used to purchase furniture and equipment. That $1 million is excluded remodel-refresh costs, and the remaining $2 million is considered qualified costs. Under the safe harbor of accounting, 75 percent of the $2 million of qualified costs ($1,500,000) is treated as deductible in the year the property is placed in service, and the remaining 25 percent of the $2 million ($500,000) is capitalized and depreciated.

Who qualifies? A taxpayer in the business of selling merchandise to customers at retail or preparing and selling meals to customers for consumption.

What is the effective date?

The revenue procedure is effective immediately for tax years beginning on or after January 1, 2014.

This article is a brief overview of the revenue procedure providing for a safe harbor method of accounting for certain remodel and refresh expenditures. There are specific criteria that must be met to qualify. You should discuss your specific situation with your tax adviser to determine if this safe harbor method of accounting could benefit you.

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