Repairs vs. Improvements

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Repairs vs. Improvements

Generally, a current business deduction is allowed for the cost of repairs and maintenance incurred during the year. On the other hand, the amounts paid to acquire, produce, or improve tangible property must be capitalized. Since repairs and improvements often have very similar characteristics, it can be tricky to classify the expenditures. Correct classification is important because the cost of repairs can generally be deducted in the year paid, while improvements must be capitalized and the deduction taken over several years through depreciation.

An improvement requiring capitalization occurs with an addition to or partial replacement of property that results in a betterment of the unit of property, restores the unit of property, or adapts the unit of property to a new use. The cost of an improvement must be capitalized and depreciated over a certain number of years as if the improvement were separate property.

Example: *Nina has a truck she uses for her contracting business. Her truck was damaged and the cost to repair it is considered a deductible repair cost. Routine maintenance on the truck such as engine tune-ups and oil changes are also currently deductible expenses. Nina added a hydraulic lift to her truck, which improved its functionality. The expense of adding the lift is an improvement that must be capitalized and depreciated over the truck's remaining useful life.*

Example: *Glen owns a rental house and the roof on the unit is leaking. Glen is comparing the costs and benefits of fixing the leaking roof with replacing the entire roof. Glen can deduct the cost of repairing the leak as a rental repair expense. However, if Glen completely replaces the roof, the new roof is an improvement because it increases the value and lengthens the life of the property. Glen must capitalize and depreciate the cost of a new roof.*

Common Repairs vs. Improvements

Repairs	***Improvements***
Costs that: • Keep the property in good operating condition. • Do not materially add value to the property. • Do not substantially prolong the property's life.	Costs that: • Improve or better the property. • Restore the property. • Adapt the property to new or different uses.
Deductible as a current expense.	*Must be capitalized and depreciated.**
Examples: • Repainting inside or out. • Fixing gutters. • Fixing damaged carpet. • Fixing leaks. • Plastering. • Replacing a broken window. • Servicing office equipment. • Cleaning and lubricating machinery.	Examples: • Room additions. • Remodeling. • Landscaping. • New roof or flooring/carpeting. • Wiring upgrades. • New heating/cooling and plumbing systems. • Installing a security system. • Replacing gravel driveway with concrete.

* The cost of an improvement is depreciated according to a prescribed class and recovery period of the underlying property. Most non-real estate assets such as computers or machinery are depreciated over five or seven years, with residential real estate depreciated over 27½ years, and nonresidential business property over 39 years.

Example #1: *Penny owns an office building with 24 exterior windows. The windows are 25% of the total surface area of the building. She replaces 8 damaged windows and does not plan to replace others. The cost is a repair and currently deductible because she is not replacing a major component or substantial structural part of the building.*

Example #2: *Assume the same facts as Example #1, except Penny replaces 16 of the 24 windows. The cost must be capitalized as an improvement because 16 windows are a major component of the building structure.*

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Example #3: *Assume the same facts as Example #1, except the 24 windows represent 90% of the total surface area of the building. The cost must be capitalized as an improvement because 8 windows comprise a substantial structural part of the building.*

Business Use Requirement

Repairs are deductible only on business-use or rental property. A homeowner with no business use of the home does not benefit when an expenditure is classified as a repair rather than an improvement. Repairs are nondeductible personal expenses, while an improvement increases the basis of the home and reduces any potential gain on the sale of the home.

Example: *Olive repaired a hole in the wall in her living room, replaced a few broken tiles in her bathroom, and sealed some cracks in her windows. She spent $1,200 making repairs to her home. Because Olive does not use her home for business purposes, the $1,200 is a personal expense and is not deductible.*

Recordkeeping

Keep good records and ask contractors to provide an itemized list showing repairs and separately stated improvements and costs. If repairs and improvements are all completed at the same time, the IRS may classify the entire cost as improvement, even if some of the expenses were for repairs.

Court Case: A taxpayer incurred expenses to add a lunch area, restrooms, and a loading and unloading ramp to his existing manufacturing plants. In addition, the interior of the plants were painted and 'fixed-up.' He claimed a deduction for all the costs as repairs and maintenance and argued that the expenses were for maintaining the property in an ordinary, efficient operating condition. The IRS disallowed the deduction and argued that expenses for additions and improvements which prolong the life of property or increase its value are capital expenses and not currently deductible as repairs and maintenance costs. The court agreed with the IRS, noting that the additions of the lunch room, restrooms, and ramps constitute nondeductible capital expenditures that were more than merely keeping the property in an ordinarily efficient operating condition. The additions and improvements not only increased the value of the plants, but also aided in adapting them to a different use. The painting of the facility would qualify as a deductible repair if those expenses were standing alone, however, when made as part of an entire capital investment in the improved property, as they were in this case, they must be treated as a capital expenditure. In addition, the court noted that it was not possible to determine from the evidence submitted what portion, if any, was attributable to deductible repairs. Without a segregation of expenses, the deduction cannot be allowed and all expenditures must be capitalized. (*Rutter*, T.C. Memo. 1986-407)

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 73.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of $5,000.