

## CLIENT ALERT

### IRS Publishes Safe Harbor Permitting Retailers and Restaurateurs to Deduct Remodeling Costs

November 23, 2015

Retailers and restaurateurs have had substantial controversy with the IRS over how much of their remodeling or "refresh" costs are currently deductible. Although recent regulations under I.R.C. §263(a) attempted to address some of the issues, the guidance in the regulations was insufficient to address the variety of complicated projects that retailers and restaurateurs undertake.

To reduce controversy, on November 19, 2015, the IRS issued a safe harbor procedure, Rev. Proc. 2015-56, under which retailers and restaurateurs may deduct 75 percent of remodeling costs and must capitalize and depreciate the remaining costs. While some retailers and restaurateurs may be able to properly deduct a higher percentage of remodeling costs by applying the regulations, they must balance the higher deduction against the cost of undertaking a detailed factual analysis necessary to determine and support a higher deduction, and the possibility of continued controversy with the IRS. Therefore, we expect that most retailers and restaurateurs will want to use the safe harbor.

To use the safe harbor, retailers and restaurateurs must file an application, Form 3115, with the IRS to change their method of accounting. The application is filed under the "automatic consent" procedures of Rev. Proc. 2015-13 (that is, consent is "automatically" granted by the IRS to use the safe harbor). Once it uses the safe harbor, the retailer/restaurateur must continue to use it for all remodeling costs, unless and until it receives permission from the IRS to change to another method.

As part of the change to the safe harbor, retailers and restaurateurs must compute a "catch-up" adjustment under I.R.C. §481(a). The adjustment is reported on the federal income tax return for the year of change as an item of income, if the retailer/restaurateur previously deducted more than 75 percent of remodeling costs, or an item of deduction, if the retailer/restaurateur previously deducted less than 75 percent of remodeling costs. The retailer/restaurateur also must adjust the basis of the remodeled property by the amount of the catch-up adjustment (increase the basis for an income adjustment or decrease the basis for a deduction adjustment).

Retailers and restaurateurs can begin to use the safe harbor for their taxable years beginning on or after January 1, 2014.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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