The Tax Aspects of Roof Replacements

By Charles Goulding, Jacob Goldman and Taylor Goulding

Charles Goulding, Jacob Goldman and Taylor Goulding describe the factors taxpayers must consider when determining the tax treatment of roof replacements. They discuss the betterment test, restoration test and adaptation test, which provide taxpayers with guidance in determining which costs must be capitalized and which costs can be expensed.

For commercial buildings, one of the more costly inevitable expenditures is the replacement of an existing roof. Recent proposed and re-proposed regulations[1] aimed at codifying tax case law make it clear that in certain cases the cost of replacement roofs, including materials and installation labor, can be expensed as repairs for tax purposes. Conversely, in certain cases, the proposed regulations and existing tax case law make it clear that required expenditures for a replacement roof should be capitalized. Note that the proposed regulations will not be considered law until and unless they are finalized.

The first section of this article discusses the tax rules. The second section of this article explains how to apply the roof replacement tax rules based on the technical aspects of roof products.

The Tax Rules

For buildings, the re-proposed and proposed repair regulations are based on the *FedEx Corp.*[2] and *Ingram Industries, Inc.*[3] cases, which indicate that for repair expense purposes, a building is considered a unit of property. If a component of a unit of property is replaced and meets a series of tests, it should be eligible for repair expensing. The three tests are:

1. The Betterment Test
2. The Restoration Test
3. The Adaptation Test

The Betterment Test provides a variety of materiality, performance and efficiency criteria that are aimed at determining whether or not a tax betterment has occurred. This is the area where a taxpayer needs to understand roof product functionality as described in this article, below.

The Restoration Test asks whether the component extends the useful life of the unit of property. A stand alone roof replacement typically is not going to extend a building's useful life.

The Adaptation Test requires capitalization if the replacement roof enables the unit of property to have a different use. A typical replacement roof on a building that continues to be used for the same purpose will meet this test. As the United States continues to move from a manufacturing economy to a service economy, it is common to see industrial properties converted to other uses. In this situation, if the new roof is part of a facility project where industrial space is changed to office space or retail space, then capitalization will be required.

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Understanding Roof Products

Roofs are typically characterized by predominant material type, including but not limited to:

1. Wood shingle roofs
2. Asphalt roofs
3. Metal roofs
4. Rubber roofs
5. Concrete and tile
6. Single ply chemical roofs

Roof material technology continuously evolves and many synthetic materials (chemical roofs) are increasingly used in today's roofs.

> The question of whether a roof replacement is a betterment in a tax context is highly dependent on facts and circumstances. Qualified roof replacements should be eligible for repair expense treatment, but taxpayers need to create a strong supportive documentation package.

Roof Replacement Alternatives

Roof replacement ranges from:

1. Built-up systems whereby existing roofs are built back up
2. Similar roof replacements
3. Entirely new roof systems

Built-up Systems

Built-up systems are categorized as roofs that are rebuilt, often with fiberglass felts or rubber modified asphalt flashing materials. Built-up roofs result in lower building replacement costs and strive to use the retained roofing as a foundation base and insulation layer. When documented, most built-up roofs should qualify for repair expense treatment.

Similar Roof Replacements

Quite often, roofs are replaced with similar roof materials or roofs that are essentially the same in form and function. Although materials may be substituted, the new roof performs, for the most part, as the old roof did. In similar roof replacement situations, taxpayers will need to document repair expensing in accordance with case law and the proposed regulations when finalized.

New Roof Systems

New roof systems can range from new materials with substantially different performance characteristics to roof systems with entirely different functions like BIPV solar roofing, which is building integrated photovoltaic roofing that enhances the roof to make it an electricity generator.

To obtain a roof replacement expense deduction the new roof cannot be considered a betterment in a tax sense. The March, 2008 re-proposed regulations provide three examples to illustrate these concepts, which we have summarized for case of reference using the same example numbers:

Example 9

Here the taxpayer, a retailer, re-shingles a wooden roof with a wooden roof as a result of a storm. All of the other tax tests are met and there is not a disqualifying event. The conclusion is that this replacement is a non-betterment.

Example 10

Here the underlying facts are the same but the taxpayer decided to replace the wooden shingles with comparable asphalt shingles. Even though it is recognized that the asphalt shingles may be stronger than the wooden shingles, it is still not considered a betterment since it is not considered practical in today's market to install wooden shingles. Although the example does not go into detail, our presumption is that the drafters realize that wooden shingles are known to increase fire risk, are prohibited by fire codes in many jurisdictions, and asphalt shingles are mainstream replacement roof materials.

Example 11

Again, the underlying facts involve the same situation but the taxpayers decide to replace the wooden shingles with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture. The new shingles have a 50 year warranty and class A fire rating. Here, the conclusion is that this replacement is a betterment that must be capitalized. Rubber roofs and other composite roof materials have been in the market for decades, so many project owners will, in fact, be replacing rubber and composite roofs with rubber and composite roofs. The issue of whether these are betterments will depend on the criteria illustrated in example 11.

Nonqualified Roof Replacement

If the replacement roof relates to a recognized tax loss transaction or casualty loss deduction, then the tax repair provisions are not applicable. Also, if the roof was known to be defective at the time of the building purchase, the replacement repair expense treatment for tax purposes is not available.

Understanding Roof Warranties

Since a roof replacement is a large expenditure and leakage can result in substantial property damage, owners are interested in warranty provisions, and warranties are often used as a selling tool. Like other products, roof warranties vary widely based on length and scope of coverage. Typical roof material warranties range from 10, 20 and 30 years, up to 50 years and lifetime warranties. Warranty coverage may be limited to roofing material or cover both materials and insulation. Roofing contractors offer shorter warranties, *e.g.,* two years installation and labor, whereas manufacturers typically offer the longer materials only warranties. Although the length of the warranty may be an indication of material attributes, in theory, the warranty itself is not determinative of whether a roof replacement qualifies for a roof replacement expense deduction. When purchasing other roof products, such as skylights; heating ventilation and air conditioning (HVAC) equipment; and solar photovoltaic (PV), facilities managers need to be sure that warranty protection is not compromised.

Understanding Roof Energy Performance

The energy performance of a roof is based on its thermal building envelope achievement or what is commonly called its R value. A roof is considered part of the building envelope, meaning it is one of the items that creates the perimeter of the building touching the outside world. Other building envelope items include doors, windows, walls and foundations. Property owners should consider using objective R value criteria to segregate betterment roof replacements from non-betterment roof replacements. Some of the criteria that should be considered are American Society of Heating Refrigeration, and Air Conditioning Engineers (ASHRAE) standards, local building energy code standards, geographical region in the United States and industry practice.

Insulation

Roof replacement often involves the installation of replacement or supplemental insulation, especially if the existing roof is going to be stripped. The proposed regulations indicate that if existing asbestos insulation (from a time when the hazards of asbestos were not well known) is replaced, then repair expense treatment may be available. Insulation has its own standard R value which should be considered as part of a betterment evaluation.

Sheathing and Rafters

Sheathing and Rafters may be part of the replacement repair expense if the other tax tests are met. The March 2008 proposed regulations contain an example where the contractor inspects the roof and finds that a major portion of the sheathing and rafters have rotted. The example presumes that a roof does not comprise more than 50 percent of the cost to acquire a new store. The example concludes that with these facts, the new roof, sheathing and rafters are not a major component or substantial structural part of the store, and accordingly, that tax capitalization is not required.

Cool Roofs

Cool roofs are roofs that reduce roof surface temperature, thereby reducing the heat transfer into the underlying building below. These roofs reduce energy costs, increase roof life cycle and reduce urban heat islands. Increasingly, more and more jurisdictions, particularly sun intensive jurisdictions, are mandating cool roofs by building energy codes. Cool roof replacements range from merely repainting the roof surface in a reflective color (generally white), which should qualify for expense treatment, to alternative cool roof materials, which may or may not require capitalization. The issue of whether a replacement cool roof qualifies for repair expense is going to depend on all the facts and circumstances as described in the previous sections of this article.

Metal Roofs

It is quite common in Maine, Vermont and other heavy snow regions to increasingly see metal roofs with sleek, slide-like sections that cause the snow to slip off. One of the important roof considerations in these areas is the load bearing capabilities of the roof structure. Presumably, in these regions, load bearing will be one of the factors to consider. The problem with the previous generation of wooden roofs in these regions is that the sheathing and rafters often rotted, as described in the *Sheathing and Rafter* section above.

Conclusion

Roof replacements are expensive and may only occur within 20 to 40 year cycles. Wooden and other less durable materials are increasingly being replaced with improved materials, which may be used because of industry practice, climate conditions or changes in building energy codes. The question of whether a roof replacement is a betterment in a tax context is highly dependent on facts and circumstances. Qualified roof replacements should be eligible for repair expense treatment, but taxpayers need to create a strong supportive documentation package.

Endnotes

1 The re-proposed regulations under Code Sec. 263(a) provide guidance regarding the deduction and capitalization of expenditures related to tangible property. 73 FR. 12838 (Mar. 10, 2008). The 2008 proposed regulations supersede the August 21, 2006 proposed regulations (71 FR. 161).

2 *FedEx Corp.*, DC Tenn., 2003-2 USTC ¶50,697, 291 FSupp2d 699, *aff'd* in an unpublished opinion, CA-6 2005-1 USTC ¶50,186, 412 F3d 617.

3 *Ingram Industries, Inc.*, 80 TCM 532, Dec. 54,088(M), TC Memo. 2000-323.