Dear Client:

We are writing to let you know about an important development that will affect every business. The IRS has issued final regulations on the tax treatment of amounts paid to acquire, produce, or improve tangible property. The regulations explain when those payments can be deducted for an immediate tax benefit, and when they must be capitalized and subsequently depreciated. The regulations must be followed for tax years that begin after December 31, 2013. The regulations are lengthy and complex. The summary below is intended to give an overview of how they treat issues of deduction and capitalization. We would be happy to discuss the regulations with you in more detail and review how they will affect your specific business situation.

Capitalization or deduction: The regulations set forth the general rule that amounts paid to improve a unit of property must be capitalized. An improvement is defined as an expenditure that betters a unit of property, restores it, or adapts it to a new and different use. On the other hand, the regulations allow a current deduction for repairs and maintenance to property only if not otherwise required to be capitalized.

Unit of property: One key concept in the regulations is the "unit of property" (UOP) that is being improved or repaired. The smaller the UOP, the more likely it is that costs incurred in connection with it will have to be capitalized. For example, work on an engine of a vehicle is more likely to be classified as an expenditure that must be capitalized if the engine is classified as a separate UOP. By contrast, the engine work has a better chance of qualifying as a repair expense if the vehicle is the UOP.

Property other than buildings: For property other than buildings, a single UOP consists of all components that are functionally interdependent, so that one component can't operate without the other components. For example, a business buys a battery-powered golf cart for its foreman to use in getting around a large warehouse. It buys the chassis from one vendor and the battery from another, and then assembles the two components. The cart is the UOP, since the chassis can't operate without the battery, and both components would be capitalized.

Buildings: When it comes to buildings, the regulations treat each building and its structural components as one building UOP. The regulations also list nine specific building systems that are treated as separate from the building structure. An improvement to the building is defined by its effect on those systems, rather than on the building as a whole. For example, if a taxpayer restores a building structure, such as by replacing the entire roof, the expenditure is treated as an improvement to the single UOP consisting of the building. If the taxpayer makes an improvement to a building system, such as the heating, ventilation, and air conditioning (HVAC) system, that expenditure is also an improvement to the building UOP.

Materials and supplies: A deduction is allowed for amounts paid to produce and acquire materials and supplies that are consumed during the year. Materials and supplies are defined to include five specific categories of property used or consumed in the business operations. For example, UOPs with an economic useful life of no more than 12 months qualify as materials and supplies under this rule. Likewise, UOPs that cost $200 or less to acquire or produce, qualify as materials and supplies.

De minimis safe harbor: The regulations allow a taxpayer to deduct certain limited amounts paid for tangible property that are expensed for financial accounting purposes. For most businesses, the maximum figure is $500. A taxpayer with an applicable financial statement (AFS) is allowed $5,000. An AFS can be a certified audited financial statement used for credit purposes, reporting to partners, or other non-tax purposes. The de minimis safe harbor amount paid for the property is per invoice, or per item as substantiated by the invoice. To use the safe harbor, a business must have accounting procedures in place at the beginning of the tax year that treat amounts paid for property costing less than a specified dollar amount or with an economic useful life of nor more than twelve months as an expense.

Routine maintenance safe harbor: The regulations include a safe harbor that allows certain expenses of routine maintenance to be deducted rather than capitalized. Routine maintenance means recurring activities that keep business property (including buildings) in ordinarily efficient operating condition, such as inspections, cleaning, testing and replacement of damaged or worn parts. For a building structure or system, the taxpayer must reasonably expect to perform the maintenance more than once during the ten year period that begins when the structure or system is placed in service. For property other than buildings, the taxpayer must reasonably expect to perform the activities more than once during the depreciable life of the property.

Per-building safe harbor for qualifying small taxpayers: The regulations include a safe harbor that allows qualifying small taxpayers (average annual gross receipts of $10,000,000 or less in the three preceding tax years) to deduct improvements made to a building property with an unadjusted tax basis of $1,000,000 or less. This safe harbor applies only if the total amount paid during the tax year for repairs, maintenance, and improvements to the building doesn't exceed the lesser of $10,000 or 2% of the building's unadjusted tax basis. This safe harbor may be elected annually on a building-by-building basis. It is elected by including a statement on the tax return for the year the costs are incurred for the building.

Accounting method changes: A change to conform to the regulations is considered a change in accounting method, for which an accounting adjustment is required. The IRS has issued procedures under which taxpayers can get automatic consent to the accounting method change.

Please give us a call if you have any questions or need any assistance with these regulations.

Sincerely,

Friedman & Perry, CPA’s