

CLIENT MEMO: Will the new “repair regulations” affect your business?

After years of work, the IRS has finally issued regulations clarifying for the business community when costs related to fixed assets must be capitalized and when they can be expensed.

■ To expense or capitalize? What’s the difference?

Generally, the cost to acquire, produce, or improve tangible property must be capitalized and depreciated over a number of years. On the other hand, the cost of repairing and maintaining fixed assets is deductible in the year of the expense.

The difficulty has been distinguishing between the two kinds of costs. Is the expense a “repair or ordinary maintenance” that can be deducted on the current year’s tax return, or is it an “improvement” that must be capitalized and depreciated over the life of the asset?

If you buy, build, or repair business assets, you probably have questions when trying to decide whether your costs are currently deductible on your federal income tax return or whether they’re capital improvements.

Since deductions for capital improvements are typically spread over the life of an asset, the answer can be important even when accelerated depreciation methods are available.

The new “repair regulations” are the IRS’s attempt to clarify when costs may be currently deducted and when they must be capitalized. The newly issued tax rules can make the expense-or-capitalize decision easier for your company. These repair regulations provide guidelines and safe harbors to help you determine when certain purchases and expenditures are considered repairs, maintenance, improvements, materials, or supplies that can be deducted in the year of purchase.

■ Safe harbors in the new rules

Here’s an overview of safe harbor rules that may affect the way you classify expenses.

▶ De minimis purchases

In general, you can deduct the cost of tangible property purchased during a taxable year if the amount you pay for the property is less than \$500 per invoice, or per item. This is an all-or-nothing rule, meaning if an asset costs more than \$500, you cannot take a partial deduction.

To take the deduction, you’ll need a written accounting policy in place by the beginning of your tax year, and you’re required to file an annual statement with your federal tax return.

Note: This safe harbor does not apply to intangible assets such as computer software.

► **Repairs and maintenance**

You can expense costs for routine maintenance of buildings and other property. For buildings, “routine” means maintenance you expect to perform more than once in a ten-year period. The costs for material additions or defects or for adapting your property to a new or different use are not considered routine maintenance, and they should be capitalized.

For other assets, “routine” is defined as maintenance you expect to undertake more than once during the asset’s depreciable class life.

► **Improvements**

Generally, improvements you make to your business building are capitalized and depreciated over the life of the building. Under the new rules, if your business’s gross receipts are ten million dollars or less and the unadjusted basis of your building is one million dollars or less, you may choose to write off the cost of improvements.

You can make the election annually on a building-by-building basis for property you own or lease by filing a statement with your tax return. To qualify, the total amount you pay during the year for repairs, maintenance, and improvements cannot be greater than \$10,000 or 2% of the unadjusted basis of the building, whichever is less.

Note: The total includes amounts you deduct under the “repairs and maintenance” and “de minimis” safe harbors.

► **Materials and supplies**

Incidental materials and supplies (supplies for which you do not maintain an inventory) costing less than \$200 can be expensed in the year of purchase.

Note: This safe harbor does not affect prior rules for deducting materials and supplies, such as restaurant smallwares.

■ **Complex regulations include last-minute easing of the rules**

The repair regulations are effective for tax years beginning after 2013, so they will apply to your 2014 federal income tax return. In some cases, you can apply the new rules to prior years.

A new Revenue Procedure 2015-20 was issued by the IRS on February 13, 2015, easing the repair regulation requirements for small businesses. According to the IRS, the new procedure “allows small businesses to change a method of accounting under the final tangible property regulations on a prospective basis for the first taxable year beginning on or after January 1, 2014.” The IRS goes on to say it is “waiving the requirement to complete and file a Form 3115 for small business taxpayers that choose to use this simplified procedure for 2014.”

The IRS defines a small business, including sole proprietors, as one with assets totaling less than \$10 million or average annual gross receipts totaling \$10 million or less.

Suggesting the possibility of even more changes in the future, the revenue procedure requests comment on whether the \$500 safe-harbor threshold in the repair regulations should be raised for businesses that choose to deduct, rather than capitalize, certain capital expenses.

The repair regulations are more than 200 pages long. Filled with various effective dates, requirements, definitions, exceptions, and safe harbors, they are anything but concise and clear. As with any part of the tax law, these regulations contain numerous complex provisions that could result in tax savings or additional costs for your business. If your company owns or leases fixed assets, contact us for assistance in applying the rules to your business.

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