

3/12/14

Regulations for Business Expenses

Final Regulations Issued on Treatment of Tangible Property

The IRS has issued long-awaited regulations that will affect virtually every business. The regulations clarify and finalize the tax treatment of amounts paid to acquire, produce or improve tangible property. The regulations explain when those payments can be deducted—which confers an immediate tax benefit—and when they must be capitalized.

The final IRS regulations for deducting and capitalizing expenses retain many provisions of the temporary ones that were issued in 2011. However, the final regulations refine and simplify the temporary ones and also add new safe harbor provisions that assist in determining expense deductions. The regulations are lengthy and complex. The summary below is intended to give an overview of how they treat issues of deduction and capitalization.

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 better 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. Deductible repair and maintenance expenses are defined in a negative way—they are deductible if not otherwise required to be capitalized.

Unit of Property

One key concept 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 expense that must be capitalized if the engine is classified a separate UOP. By contrast, if the UOP is the vehicle, the engine work has a better chance of passing muster as a repair.

Property Other Than Buildings

In general, for property other than buildings, a single UOP consists of all components that are

functionally interdependent, such that one component can't be placed in service without the other components.

For example, consider a business that 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. Here, the cart is the UOP, since the chassis can't be placed in service without the battery.

Buildings

When it comes to buildings, the regulations generally treat each building and its structural components as one UOP—the “building.” They 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.

If a taxpayer restores a building structure, such as by replacing the entire roof, the expense 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 expense is also an improvement to the building UOP.

Deducting 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.

UOPs with an economic useful life of no more than 12 months qualify as materials and supplies under this rule. Likewise, certain inexpensive items qualify as materials and supplies. Under the final regulations, this rule applies to UOPs that cost \$200 or less to acquire or produce, an increase from the \$100 threshold in the 2011 temporary regulations.

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. Under the 2011 temporary ones, this de minimis safe harbor was only available to taxpayers that had an applicable financial statement (AFS), which can be a certified audited financial statement used for credit purposes, reporting to partners, or other non-tax purposes. The final regulations change this by allowing businesses without an AFS to use the de minimis safe harbor.

A taxpayer with an AFS may rely on the de minimis safe harbor if no more than \$5,000 per invoice, or per item as substantiated by the invoice, was paid for the property. For businesses without an AFS, the maximum figure is \$500 rather than \$5,000.

To use the safe harbor, the business must have accounting procedures in place at the beginning of the tax year that treat as an expense amounts paid for property that costs less than a specified dollar

amount or has an economic useful life of 12 months or less. I can assist you in making sure that your business meets these requirements.

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 in ordinarily efficient operating condition, such as inspection, cleaning, testing, and replacement of damaged or worn parts.

Under the 2011 temporary regulations, this safe harbor wasn't available for building maintenance. The final ones expand the safe harbor to cover buildings as well.

For a building structure or system, the taxpayer must reasonably expect to perform the maintenance more than once during the 10-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 property's class life for depreciation purposes.

Per-Building Safe Harbor for Qualifying Small Taxpayers

The final regulations add a new safe harbor that allows qualifying small taxpayers—those with average annual gross receipts of \$10 million or less in the three preceding tax years—to deduct improvements made to a building property with an unadjusted basis of \$1 million 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 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. I can help you to take advantage of this rule by filing the necessary election.

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 plans to issue procedures under which taxpayers can get automatic consent to the accounting method change.

Effective Date

The regulations must be followed for tax years that begin after Dec. 31, 2013—whether a calendar year or a fiscal year—such as a fiscal year beginning July 1, 2014. Taxpayers have the option of applying the final ones retroactively to the 2012 and 2013 tax years.

~

If you have any questions, please feel free to contact your Seiler professional at (650) 365-4646 or email info@seiler.com. We would be happy to discuss appropriate courses of action for your particular circumstance.

About Seiler LLP

Established in 1957, Seiler is a leading accounting firm serving affluent clients, closely held businesses and non-profit organizations throughout the United States and the world. From our offices in San Francisco and the Silicon Valley, we offer highly sophisticated solutions and innovative thinking in the areas of tax and estate planning, charitable gift planning, audit and assurance, real estate, family office and litigation support. At Seiler, our mission is to provide the knowledgeable advice and guidance our clients require to navigate the complexities of their financial worlds not only today, but also for the many years to come. For more information, please visit www.seiler.com.

Silicon Valley Office

Three Lagoon Drive, Suite 400
Redwood City, CA 94065
Main: 650.365.4646
info@seiler.com

San Francisco Office

220 Montgomery Street, Suite 300
San Francisco, CA 94104
Main: 415.392.2123
info@seiler.com

Named a "Top 100 Accounting Firm" in the U.S. by *INSIDE Public Accounting Magazine*

Named a "Best of the Best Top Accounting Firm" in the U.S. by *INSIDE Public Accounting Magazine*

IRS Circular 230 Disclosure:

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Privilege Disclaimer:

The information transmitted is intended only for the person or entity to which it is addressed and may contain confidential and/or privileged material. Any review, retransmission, dissemination or other use of, or taking of any action in reliance upon, this information by persons or entities other than the intended recipient is prohibited. If you received this in error, please contact the sender and delete the material from any computer.

© 2014, Seiler LLP

This content is for general information purposes only, and should not be used as a substitute for consultation with professional legal, tax or accounting advisors.