Tangible Property Regulations

In general, taxpayers are required to capitalize amounts paid to acquire or produce a unit of property. New rules allow for optional treatments, if the either elections or accounting changes are made. Depending on the rule, it is either an annual election or a permanent accounting change.

Rule changes that require an annual election made before the start of the year:

- **De minimis safe harbor election**
  - Expense, instead of capitalizing purchases made during the year of $500 or less. (If audited financial statements are required for the business, the amount can be increased to up to $5,000. Audited financial statements are involved detailed audits of books and generally only required for very large businesses. The cost to prepare them is usually in the many thousands of dollars.)
  - Does not apply to the following:
    - Inventory purchases (which are never capitalized and always deducted when sold)
    - Land (as if you could find some for $500)
    - Rotable, temporary and emergency spare parts (things you have on hand "just in case" such as a spare tire)
      - An election can be made to capitalize these (deduct over time)
      - If the above election is not made, these are not deductible until they are disposed (they are tracked on the balance sheet until that time)
- **Small Taxpayer Safe Harbor**
  - Taxpayer must have average annual gross receipts of $10 million or less
  - Taxpayer owns eligible real estate with an unadjusted basis of $1 million or less (think purchase price plus improvements already being capitalized)
  - For leased property, the total amount of lease payments for the term of the lease is the unadjusted basis. This amount must also be less than $1 million dollars.
  - Total amount paid during the year for repairs, maintenance and improvements on the eligible building property does not exceed the lesser of
    - 2% of the unadjusted basis or
    - $10,000
  - If all of the above conditions are met, an election can be made to deduct the full price of the repairs, maintenance and improvements in the current year rather than capitalizing them over a period of time that can be up to 39 years.
- **Election to Capitalize all repairs and Maintenance Costs in the current year**
  - Might be a good idea in a year where there are more deductions than income so the deductions will still be available in the future
  - Can be made after the year

Rules that require an Accounting Method Change Form 3115 – Or Under Rev Proc 2015-20, if gross receipts and assets are below $10,000,000, then this can be adopted without filing a 3115, though audit protection will not be extended to prior years unless a 3115 is filed.

- **Safe Harbor for Routine Maintenance**
    - Deduct in the current year repairs and maintenance according to the following definition:
        - For Real Property Repairs/maintenance are things done, or expected to be done, at least twice every 10 years
        - For any proper other than real estate, repairs and maintenance are things done or expected to be done at least twice in the class life. Class life is the period assigned by the IRS for different kinds of property to last. Most property is 7 year property. The list of what property is what class is VERY Long – if you have questions, please consult your tax professional regarding specifics.
        - This does not apply to costs required to put the property in service (you cannot deduct as a repair or maintenance any costs incurred before the property is used as business or rental property – those expenses must be capitalized)
        - The costs are not a factor
    - Routine Maintenance does not include the following:
        - Amounts paid for the betterment of a unit of property
        - Amounts paid for the replacement of a component of a unit of property for which a gain or loss has been properly accounted for the component
        - Amounts paid for the restoration of damage to a unit of property for which a casualty loss applies
        - Amounts paid to return a unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its use.
        - Amounts paid to adapt a unit of property for a new or different use
        - Amounts paid for repairs, maintenance or improvements of network assets
        - Amounts paid for repairs, maintenance or improvement of rotable and temporary spare parts which the taxpayer is not capitalizing
- **Adopting a policy for materials and supplies allowing more for more favorable tax treatments**
    - **Materials and Supplies are defined as any one of the following**:

    - A component acquired to maintain, repair or improve a unit of property owned, leased or serviced by the taxpayer and that is not acquired as part of any unit of property
    - Fuel, lubricants, water and similar items that are reasonably expected to be consumed in 12 months or less
    - A unit of property that has an economic useful life of 12 months or less beginning when the property is used or consumed by the taxpayer (this can be even if the class life is longer) - this one can be a pretty big deal.
    - A unit of property with an acquisition or production cost of $200 or less
    - Other property as identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as materials and supplies
  - **Further described as one of these**:
    - **Incidental** materials and supplies are small in operational and financial sense. There is no record of consumption kept and no physical inventory is taken. Adopting this policy allows for deducting these items when paid, provided taxable income is clearly reflected. Determining what is incidental depends on the facts and circumstances of each taxpayer. Things taken into consideration are business size, number of employees, number of locations, annual gross receipts, industry standards and many other factors. Many items that are otherwise depreciated could be classified as an incidental material or supply and deducted currently if the new rules are adopted. Otherwise, materials and supplies with a class life greater than 1 year are required to be capitalized, no matter the cost.
    - **Non-incidental** materials and supplies are materials and supplies that are carried on hand, and a record of consumption is kept or a physical inventory is taken. They are not deductible when paid, they are deductible when first used or consumed in the business. This is preferable to depreciating these items over up to 7 years, which is the requirement if this change is not adopted.
    - **Rotable, temporary spare parts** are materials and supplies acquired for installation on another unit of property. These items are removable and can be used installed on another unit of property after removal from the first (think spare tire).
      - **This type requires a choice**
        - Deduct when disposed, which is required if the new rules are not adopted
        - Deduct over time (capitalized), which is the new option to choose to adopt
  - Materials and Supplies consumed in the improvement of property are not treated as materials and supplies and must be treated as part of the improvement if they are consumed in the overall process of the improvement.

        - A piece of pipe can be a material or supply if it is kept on hand in case a water line bursts. In this case it is an incidental supply deducted when purchased.
        - If that piece of pipe were part of the process of installing a new irrigation system, they are part of an overall improvement and are capitalized as the improvement.

- **An Improvement is something that results in the a change to property as a**
        - BETTERMENT – makes an asset better than it was before: think putting a 300 hp motor in equipment that used to have a 250 hp motor, or think adding solar to a house, or upgrading countertops from tile to granite.
        - ADAPTATION – makes an asset able to be used for something different: think adding a lift mechanism to a truck bed thus making it a "dump truck" or converting a rental house into a commercial office space – it does not have to be that big and grand to be an adaptation – it just has to convert the asset into a different use.
        - RESTORATION – restoring something to its previous condition. This one is tricky. Most people will want to use the word "repair" when referring to a restoration. Imagine you own a rental property and the bathroom has dry rot by the tub. To fix it, you have to rip out all the flooring, subflooring, toilet, tub and sink fixtures – you have to gut the room. Once the correction is made, new flooring is laid. Even if you use the same old tub, toilet, sink and cabinet, you have now "restored" the bathroom to its prior condition. This is NOT a repair and this needs to be capitalized. Consider the 2% of unadjusted basis election for these instances. Certainly contact us to discuss how to make the distinctions between repair and restoration.
    - Regardless of whether or not the new rules are adopted, Improvements (a betterment, adaption or restoration) are capitalized, unless one of the earlier mentioned situations applies, such as the small taxpayer safe harbor.