Expense it, or capitalize it

New IRS regulations detail standards on how to categorize property repairs

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New regulations from the IRS and Treasury Department went into effect Jan. 1 relating to the deduction and capitalization of expenditures for tangible property. The regulations affect businesses of all types and sizes.

"These new rules set more guidelines on what can be done and what you have to analyze to get into the proper category," says Dennis C. Murphy Jr., CPA, Senior Manager with Skoda Minotti. "Basically it's expense it or capitalize it."

Smart Business spoke with Murphy about the new rules on how to classify repairs and maintenance on tangible property.

What is the purpose of the new rules?

Based on three standards, the regulations give companies a guideline of whether an expenditure should be treated as an expense or a capital expenditure, which needs to be depreciated in future years. An expenditure just needs to meet one of the three standards to be classified as a capital expense.

Of course, in taxpayers' eyes, the more that can be expensed, the better, since it lowers the taxable income. The new regulations give a better base to taxpayers for classifying future expenditures as either an expense or capital expenditure.

What requirements do the standards set?

The new regulations set forth three capitalization standards: betterment, restoration or adaptation.

The betterment standard applies to a repair if it is expected to correct a material condition or defect at the time of acquisition or production, results in a material addition to the unit of property, or results in a material increase in the capacity, productivity, strength, efficiency or quality of the unit of property.

The restoration category applies when an expenditure replaces a disposed component, returns the unit of property to its ordinary operating condition after the property has deteriorated to a state of disrepair and is no longer functional, or replaces a major component or substantial structural part of the property.

An expenditure results in capitalization under the adaptation category if the adaptation is not consistent with the taxpayer's ordinary use of the unit of property when it was placed into service.

What are the major benefits taxpayers might see from the regulations?

The first takes a conceptual approach. The regulations attempt to resolve past discrepancies between the IRS and taxpayers. It sets more guidelines and rules and offers more examples.

The second is a new election in the regulations relating to the partial disposition of assets. This election allows taxpayers to claim a loss on a disposed component or replaced component of a building or any other asset classified as a single unit of property. In addition, the election eliminates the instances where two of the same components or asset must be simultaneously depreciated.

For example, if a company has a building, and in 2014 added to or replaced its roof, the company can make an election on its 2014 tax return to deduct the original cost of the roof. For the 2014 tax year only, taxpayers that disposed of tangible property in prior years through abandonments, renovations and retirements but continue to depreciate these assets will be able to write them off in 2014.

Finally, the third benefit about the new tangible property regulations is a new safe harbor election regarding the de minimis rule. Under this election, taxpayers can expense costs depending upon the level of financial statement assurance the taxpayer produces on an annual basis.

There are typically three levels of financial statement assurance: the audit, the review and a compilation. If a company has an audit performed on its books, those businesses are allowed to deduct all amounts for repair or improvement less than $5,000. For taxpayers without this level of assurance, the threshold is $500.

A written capitalization policy must be in place at the beginning of the year for which the election is made.

To make sure they have all their procedures and information current in order to use the new provisions, companies should talk to a tax adviser. ●