

Guidance regarding the deductibility of amounts paid to acquire, produce, or improve tangible real or personal property.

The IRS has issued detailed rules which discuss the proper tax treatment of such expenditures. These rules apply to corporations, S corporations, partnerships, LLCs, and individuals filing a Form 1040 with Schedule C, E, or F. These rules affect you if you incur amounts to acquire, produce or improve tangible real or personal property in carrying on your trades or businesses.

One of the more advantageous features of the IRS rules is a special election under which you may elect to apply a de minimis safe harbor to amounts paid to acquire or produce tangible property to the extent such amounts are deducted by you for financial accounting purposes or in keeping your books and records. If you have an applicable financial statement (AFS), you may use this safe harbor to deduct amounts paid for tangible property up to \$5,000 per invoice or item. If you don't have an AFS, you may use the safe harbor to deduct amounts up to \$2,500 per item or invoice. These limitations are for purposes of determining whether particular expenses qualify under the safe harbor; they aren't intended as a ceiling on the amount you can deduct as business expenses. The de minimis safe harbor election eliminates the burden of determining whether every small-dollar expenditure for the acquisition or production of property is properly deductible or capitalizable. If you elect to use the de minimis safe harbor, you don't have to capitalize the cost of qualifying de minimis acquisitions or improvements. However, de minimis amounts paid for tangible property may be subject to capitalization under the uniform capitalization rules if the amounts include the direct or allocable indirect costs of other property you produced or acquired for resale. For example, you must capitalize all the direct and allocable indirect costs of constructing a new building.

Amounts paid for the acquisition or production of tangible property that exceed the safe harbor limitations aren't subject to the de minimis safe harbor election. Therefore, the safe harbor doesn't require you to capitalize all amounts paid for tangible property in excess of the applicable limitation. If an amount doesn't qualify under the de minimis safe harbor, you should treat the

amount under the normal rules that apply, i.e., currently deductible if paid for incidental materials and supplies or for repair and maintenance. This treatment is proper regardless of whether the amount exceeds the applicable de minimis safe harbor limitation. The de minimis safe harbor is simply an administrative convenience that generally allows you to elect to deduct small-dollar expenditures for the acquisition or production of property that otherwise must be capitalized under the general rules.

With respect to amounts expended for materials and supplies, such costs are deducted in the following way:

(1) If the materials and supplies are incidental, i.e., of minor or secondary importance, carried on hand without keeping a record of consumption, and no beginning and ending inventories are recorded, e.g., pens, paper, staplers, toner, trash baskets, then you deduct the materials and supplies costs in the tax year in which the amounts are paid or incurred, provided taxable income is clearly reflected.

(2) If the materials and supplies are not incidental, then you deduct the materials and supplies costs in the tax year in which the materials and supplies are first used or consumed in your operations. For example, deduct certain expendable spare parts in a trucking business for which records of consumption are kept and inventories are recorded in the tax year the part is removed from your storage area and installed in one of your trucks. However, an otherwise deductible material or supply cost could be subject to capitalization if you use the material or supply to improve property or if you incorporate the material or supply into property you produce or acquire for resale.

(3) If you elect to use the de minimis safe harbor and any materials and supplies also qualify for the safe harbor, you must deduct amounts paid for these materials or supplies under the safe harbor in the tax year the amounts are paid or incurred. Such amounts are not treated as amounts paid for materials and supplies and may be deducted as business expenses in the tax year they are paid or incurred.

Materials and supplies are generally defined to include:

(1) Acquired components - Costs of components acquired to maintain, repair, or improve tangible property owned, leased, or serviced by you and that's not acquired as part of a larger item of tangible property; or

(2) Consumables - Costs of fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in operations; or

(3) 12 month property - Costs of tangible property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in your operations; or

(4) \$200 property - Costs of tangible property that has an acquisition cost or production cost of \$200 or less.

If the amounts are not paid or incurred for an improvement to tangible property as determined under the IRS rules, then the amounts generally are deductible as repairs and maintenance. Of course, whether a cost is for repair or an improvement requires a review of the facts and circumstances surrounding the expenditure.

With best wishes for the Holiday and year to come,

Jeff

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