The *De Minimis* Rule for Capitalizing Tangible Assets

New Treasury regulations create a *de minimus* safe harbor rule for capitalizing assets. The new rule aims to better clarify whether expenditures for acquiring, producing, or improving property should be expensed or capitalized.

In general, a taxpayer must capitalize amounts paid to acquire, produce, or improve tangible property. Internal Revenue Code (IRC) §162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including the costs of certain supplies, repairs, and maintenance. The U.S. Treasury Department issued final regulations in September 2013 that provide a general framework for distinguishing capital expenditures from supplies, repairs, maintenance, and other deductible business expenses. These new regulations replace the previous temporary regulations that were to become mandatory in January 2014. They also include a revised and simplified *de minimis* safe harbor rule under Treas. Reg. §1.263(a)-1(f). These final regulations are effective for taxable years beginning on or after January 1, 2014.

There are two exceptions to the general rule of capitalization for the acquisition of tangible property. The first is the *de minimis* exception that appears in Regulation §1.263(a)-1(f), and the second is the definition of materials and supplies found in Regulation §1.263(a)-3(c)(1). The new *de minimis* safe harbor rule is intended to reduce the number of disputes between taxpayers and the IRS over whether certain types of expenditures should be expensed or capitalized. To meet this new safe harbor rule to avoid capitalization, taxpayers need to satisfy a number of requirements.

The requirements of the *de minimis* rule depend on whether or not the taxpayer has an applicable financial statement. The applicable financial statements have an order of precedence. The highest priority goes to financial statements filed with the U.S. Securities & Exchange Commission (SEC). If there is no SEC filing, the next level is a certified audited financial statement, with an independent CPA's report, that's used for either credit purposes or reporting to owners or for some other substantial nontax purpose. The last level of priority is a financial statement (which can't be a tax return) that is required to be filed with the federal or state government or one of their agencies. The critical factor is that the taxpayer has to have a financial statement that's SEC ready, audited, or submitted to a nontax governmental body or agency. Maintaining tax books alone doesn't satisfy the requirement, nor does maintaining financial accounting reports if they are only compiled or reviewed.

If a taxpayer elects to apply the *de minimis* safe harbor, then the taxpayer isn't allowed to capitalize amounts paid in the election year for acquiring or producing covered property or to treat amounts as a material or supply under Regulation §1.162-3(a) if the amounts meet the *de minimis* requirements. In other words, if the taxpayer chooses to apply the safe harbor, then all qualifying items for that year must be treated consistently.

If the taxpayer has an applicable financial statement, then the *de minimis* rule requires that, as of the beginning of the year, the taxpayer must have written accounting procedures in place that treat qualifying payments as an expense for book (financial accounting) purposes for property either valued below the dollar amount prescribed in the regulation or with a useful economic life of 12 months

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or less. The taxpayer must follow this procedure and treat the amount as an expense on its books. In addition, the amount paid for the property can't exceed $5,000 per invoice (or per item as substantiated by the invoice). This last requirement is a simplifying change from the temporary rules, which had based the limit on a percentage of gross receipts or depreciation expense.

Except for the $5,000 requirement, the rules are the same in the case of a taxpayer without an applicable financial statement. If there's no applicable financial statement, then the upper limit of the invoice (or per item) amount is lowered from $5,000 to $500. This is a significant change from the temporary regulations, which didn't provide a safe harbor for taxpayers without an applicable financial statement. While some will disagree with the lower invoice/per-item limit, this is still a significant improvement for the benefit of smaller businesses that don't produce audited financial statements.

For example, assume Nickel Corp. is a manufacturer of specialty medical gas cylinders. In 2012, it purchased a 250-ton hydraulic press that can accept multiple dies and, thus, make different-sized cylinders. In 2014, the company purchases two stands to hold the dies when they aren't in use. These stands help prevent damage to the dies and greatly facilitate change-out of the dies. The stands cost $3,500 each, as reflected on the invoices for the stands, and they are properly classified as §1245 property. Assume also that Nickel doesn't qualify for §179 expensing. Nickel is a publicly traded company, files with the SEC, and publishes audited financial statements. The company established a rule it follows regularly that requires the expensing of any item with a cost or other basis of $5,000 or less.

In order to apply the new *de minimis* rule to the example and expense the stands, the company must satisfy the requirements. Nickel has the applicable statement in its SEC filing and has a policy that it follows. Nickel must ensure that this policy was in writing by the beginning of 2014. The company acquires assets totaling $7,000 (i.e., 2 x $3,500) for which *de minimis* expensing is desired. Since Nickel has an applicable financial statement, the invoice amounts are below the $5,000 limit of the regulation, and if Nickel had the written policy in place at the beginning of 2014, then the stands can be expensed under the *de minimis* requirements in 2014. If these conditions aren't met, then the $7,000 must be capitalized.

The election is made by attaching a statement to the timely filed original federal tax return for the year in which the amounts are paid. This includes an extended return as long as it's filed timely in accordance with the extension. Treas. Reg. §1.263(a)-1(f)(5) requires that the statement be titled "Section 1.263(a)-1(f) *de minimis* safe harbor election." The election also must include the taxpayer's identifying information and an affirmative statement that the election is being made. Consolidated returns have the election made by the parent for itself and each member of the group. An S corporation or partnership makes the election at the entity level. The election is irrevocable.

Materials and supplies are defined in Regulation §1.162-3 as items of tangible property used in the taxpayer's business that fit into one of five categories. In addition, materials and supplies can't consist of items that are properly treated as inventory. The first type of material is a repair part. These repair parts can't be included in the acquisition of a unit of property; rather, they must be ones acquired to maintain or repair property. The second type of material consists of fuel, lubricants, water, and similar items that should be consumed in less than a year. The third type includes other units of property with an economic life of less than one year. The fourth type includes units of property that cost no more than $200. (The IRS changed the amount to $200 from the $100 amount that appeared in the temporary regulation.) The fifth category isn't a type of material; it's actually a note that the IRS has the right to identify additional items in future guidance. This means that materials and supplies are noninventory items that are used to repair other pieces of property, have a life of less than a year, or cost $200 at most. The useful life of the property is generally considered the period that the property is expected to be useful to the taxpayer. If the taxpayer has an applicable financial statement, then the economic life for this purpose is the life initially used for depreciation purposes in the applicable financial statement.

If the taxpayer elects to use the safe harbor provided by the new regulation, then all the materials and supplies (other than rotable-type parts) must be dealt with under the safe harbor. This is a change from the temporary regulations, which allowed taxpayers to select which materials and supplies to treat in this manner. If the safe harbor isn't elected, then the treatment of these items depends on whether they are incidental or nonincidental. Incidental materials are ones for which records of consumption aren't kept and for which inventory accounts aren't taken. The cost of these materials is deducted in the year in which the amounts are paid, as long as this doesn't distort income. If the amounts are nonincidental, i.e., those for which consumption or inventory records are kept, then they are expensed in the year in which they are used or consumed. An exception exists for rotable spare parts, which are put on property and then taken off. Rotable parts are generally expensed in the year of disposition, although there is a more complicated alternate method available.

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With regard to maintenance of property other than buildings, the final regulations retain a safe harbor for routine maintenance. Maintenance is considered routine for this purpose if the taxpayer expects to conduct the maintenance in order to keep the property working as it should and the maintenance is expected to be performed more than once during the class life of the property. An improvement over the temporary regulations is the addition of a routine maintenance provision for buildings and building systems. For the maintenance to be routine in the case of buildings, the taxpayer must reasonably expect to perform the activities more than once during the 10-year period beginning at the time the asset is placed in service.

While the dollar requirements may not be as large as some taxpayers would prefer, the new safe harbors should clarify issues related to the question of whether to capitalize or expense these types of expenditures for tangible asset costs. If they desire to use the new safe harbors, taxpayers should ensure that they have the necessary written policies in place in order to meet the requirements in the new regulations. **SF**

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