



**Notice to All Business Owners:  
Deducting and Capitalizing Business Expenses 3.0**  
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We are writing this to alert you to recent changes in federal tax law that will likely affect you significantly. The changes I am going to explain will affect the way you are required to deduct expenses related to the ownership of tangible property (**for example: buildings, land, furniture, equipment, materials & supplies, etc.**). These changes are a direct result of recently issued regulations (“regs”) from the IRS, addressing the tax treatment of amounts paid to acquire, produce, or improve tangible property. The regs impose complex rules governing when such payments can be deducted and when they must be capitalized and depreciated over time. The new rules **must be** adhered to for tax years beginning **on or after** January 1, 2014 and may entail significant time and effort to adopt and comply with.

What does this mean to you, the business owner?

For **every business that owns tangible property**, there will be at least one and, perhaps, more additional tax forms that will have to be included with your return, requesting changes in accounting methods for a number of possible aspects of property ownership, as well as a variety of elections that will have to be made with your return. For some businesses, the additional time required to comply with these new regs could be as little as one hour, while for other businesses, particularly those that own real estate, the additional time of compliance could amount to *numerous* hours.

What businesses are subject to these regs?

**Any business that acquires or owns tangible property.** If your business is corporation or partnership that files a tax return separate from its shareholders or partners, you almost certainly need to follow the steps mentioned above to comply with the regs. If you are self-employed and file a schedule C, you will also likely need to put in the time and effort to comply with the regs. If you own real estate either in your business or for rental purposes, you will, without question, have to make the effort to comply with the regs.

The important point in this notice is that compliance with these regs is not optional, it is mandatory. **Failure to do so will dramatically increase the likelihood that your business will be audited by the IRS.**

So, what is different from the way we have been treating tangible property for tax purposes? Following is

a brief summary that will be helpful in understanding the far-reaching nature of these regs.

**Capitalize or deduct?** Generally, amounts paid to improve a “unit of property” (see following) must be capitalized. An improvement is an expenditure that **better**s a unit of property, **restores** it, or **adapts** it to a new and different use. In contrast, a current deduction is allowed for repairs and maintenance to property.

**Unit of property (UOP).** This is a new term that identifies the item being improved or repaired. Generally, the lower the cost of a UOP, the more likely it is that money expended on it will have to be capitalized, and not deducted.

- **Property other than buildings.** In general, 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. Assume a business needs a battery-powered golf cart for its warehouse. If it buys the chassis from one vendor, the battery from another, and then assembles them, the cart is the UOP, since the chassis can't be placed in service without the battery.
- **Buildings.** When it comes to buildings, there is much more to pay attention to in the new regs! Each building and its structural components comprises one UOP. In addition, each of the following building systems comprises a separate UOP from the building structure: HVAC, Plumbing and Electrical systems, Escalators/Elevators, Fire/Alarm/Security Systems, and Gas Distribution Systems.

**Deducting materials and supplies.** A deduction is allowed for amounts paid to produce and acquire materials and supplies that have a useful life of a year or less, and are consumed during the year. Moreover, UOPs that cost \$200 or less qualify as deductible materials and supplies.

There are a couple of safe-harbors you need to be aware of.

- **De minimis safe harbor.** The regs allow a deduction for *limited amounts* paid for tangible property that are expensed for financial accounting purposes. Taxpayers with an “Applicable Financial Statement” (generally an audited financial statement) may rely on this safe harbor to deduct expenditures of up to \$5,000 if they have a written accounting policy in place permitting this. For businesses without an Applicable Financial Statement, the maximum amount is \$500. Again, an accounting policy must be in place permitting this but, in this case, it doesn't have to be written. What happens if you don't have a policy in place? Your ability to deduct expenditures – of any amount – that an IRS agent believes to be unreasonable could be in jeopardy!
- **Routine maintenance safe harbor.** Certain expenditures for routine maintenance may be deducted, rather than capitalized. Routine maintenance includes activities that **keep** business property in ordinarily efficient operating condition (as opposed to **putting** it in ordinarily efficient operating condition), such as inspection, cleaning, testing, and replacement of damaged or worn

parts. Additional rules apply to building structures.

The bottom line, here, is that, because of the significant record-keeping required and additional forms to be filed this year, tax returns for most businesses and lessors of real property will take significantly longer to complete. The result? Tax returns for businesses and those involved in any rental activity will, in most cases, involve significantly more documentation than they did previously, and will likely cost more to prepare. Rest assured that we will do our utmost to make the tax preparation process as efficient as possible and to minimize related fee increases.

A final note: Be forewarned that failure to comply with these new tangible property regs can result in disallowed deductions, as well as penalties and interest.

**We are here to help. Please contact us with any questions or concerns.**