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IRS HAS NEW REPAIR AND CAPITALIZATION RULES

The IRS has come out with some new regulations effective January 1, 2016. These regulations are cumbersome and were expected to be modified so that they would be simpler and friendlier to small business. That did not happen and the IRS finalized the regulations toward the end of 2015. They affect the age old issue of what is a repair and what is an improvement and have shifted the burden to the taxpayer. This affects two areas

1) Personal property **(discussed below)**
2) Real Property (real estate) **(discussed on the next 2 pages)**

They are treated differently under this IRS regulation and have different thresholds.

PERSONAL PROPERTY

Equipment, Repairs, Maintenance and Supplies-Personal Property

You are now allowed to write off any individual supply, repair, maintenance or piece of equipment costing $2,500 or less. For most businesses we suggest creating two new accounts and categorizing expenses that qualify to these accounts: “Supplies < $2,500” and “Repair/Maintenance < $2,500”. You will see why in a minute.

If the amount is over $2,500, you must decide whether it is an expense or a piece of equipment. If it is an expense, code the item to your normal category of “Supplies”, “Repair”, or “Maintenance”. Thus using the accounts in the prior paragraph will keep the costs of items under and over $2,500 items separated. If it is a piece of equipment that should be capitalized, code it to the appropriate asset account. In either case, if you use software such as QuickBooks or Quicken, describe the item in the memo area. This will allow us to quickly review what you have done. If you are chosen at random for an IRS audit, this procedure will make everything easier for you, us, and the auditor since two years will have passed and memories get a bit fuzzy over time.

What if an item costs more than $2,500? How do I know if it is an “expense” or needs to be capitalized? Any item costing over $2,500 is an expense when that item is basically used up in one year. A repair expense keeps things operating as they were or should be, as opposed to improving the item.

For example, consider hard goods. You get a $3,500 invoice from your office supplier. It includes a chrome plated printer for $2,700 and the balance is for paperclips, toner, etc. The items on this invoice have no relation to each other: staples, paper, paper clips, printer, file folders, etc. **Each item functions independently of the other items.** Here you would put the $2,500 test to each line item and code each to “Supplies”, or “Office Supplies”, except for the printer. If you go through a printer a year due to high volume, it would be computer expenses. If the printer will last longer than one year, “Depreciable Assets”.

Consider an invoice for the repair to a company vehicle. The “functioning unit” is the vehicle. So each item on the invoice **“operates dependent upon the other”.** In this case the $2,500 test would apply to the total of the entire invoice. A tune-up or oil change would be an expense, but new tires or brakes would be capitalized unless you typically go through brakes or tires in less than one year.

What about a **$3,000 super latte machine** for your employees at the office? Does it last more than a year? Probably. So it needs to be capitalized. Of course, we can use the Sec 179 to fully deduct it in one year. But, if we choose to write the machine off as an office expense and a future auditor thinks it should have been capitalized, you are now stuck with writing it off over 7 years since the Sec 179 isn’t available for prior years in an audit. The other option---buy a $2,495 **unsuper latte machine** coffee pot and write it off immediately since it cost under $2,500 or switch to tea.

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REAL PROPERTY

Real Estate-Repair vs Capitalization

The new IRS regulations allows the expensing of all repair type items (even if it improves the property) if:

1) The tax basis in the structure (not including land) is $1 million or less and
2) The total cost of repairs/improvements per building is not more than $10,000 per year (or 2% of building basis--see below).

That's right! No discussion, no analysis, no argument. If the total for the year is greater than $10,000 or the tax basis in the structure is greater than $1 million, then each item needs to be examined to determine if it is an expense item or if it must be capitalized. If capitalized, it must be depreciated over 27.5 years (residential) or 39 years (commercial).

Therefore, it becomes paramount that the category for "repair" is not simply be a dumping ground for supplies and other vague items. To the extent possible items that can be categorized elsewhere should be in order to keep the repair items as low as possible. By "categorized elsewhere" we don't mean plumbing, electrical, painting, etc. since these are repair-type items and will be included in determining the $10,000.

Trying to simplify things the IRS uses the term "unit of property". What is that? The "unit" is composed of other parts and labor that make it a "functional" whole. The "unit" is either the building itself or one of 8 subunits defined by the IRS: HVAC, plumbing, electrical, structure, elevators, security, fire protection, and gas distribution.

Expenses must be combined into the "unit". For example:

1) You install an HVAC system that was not there previously. The work takes nine months with many invoices. This is one unit.
2) You have four HVAC units and decide to replace them all at one time. The entire job takes nine months. This is one unit.
3) Same four HVAC units, but they work independently and you decide to replace one in March. A few months later, you make another decision to replace a second unit in July and then later decide to replace a third in October. These are three separate units.

Now that you have the units and have totaled up all repairs and improvements, do they exceed $10,000 or not? If the total of all repairs is greater than $10,000, what do you do? You analyze each unit to determine if it is a betterment, restoration or adaptation (see below) of the unit. If it is one of these, you must capitalize the expense and depreciate it. If it is not, but simply keeps things running as they are or should be, you have an expense.

Example: Consider repair invoices.

1) Your plumber comes out and cleans out your drain pipe to the street. This is a repair since the invoice covers work that simply keeps you operating the way you were or should be.
2) Same plumber, but he digs up and replaces your entire 30 feet of pipe. This is a depreciable item. You have replaced and upgraded the entire pipe system, making it brand new. Also, he probably booked a month-long vacation to Hawaii with the profit he made.
3) Same plumber, but this time he digs up and replaces only 4 feet of the 30 feet of piping. Is this a repair since the bulk of the old pipe is still there? A judgment call! There will always be gray areas.

If you use QuickBooks, Quicken or some similar system, we would suggest using the "memo" area to describe what the item is so we can simply use your data.

DEFINITIONS FOR WORDS USED ABOVE:

$10,000

Nothing is simple anymore. The amount is actually 2% of your basis in the building. The building basis is the purchase price, plus improvements, less the land value, not reduced by depreciation. The "safe-harbor" is capped at $10,000. So if your basis is $500,000 or more, the amount is $10,000. If your basis is less than $500,000, it is 2%.

Betterment

A betterment is fixing a condition that existed at purchase, or an increase in the physical size or capacity of the asset.

Restoration

A restoration returns a non-functional asset to use, the cost of rebuilding an asset after the end of its depreciable life or replacing a major component of the unit of property.

Adaptation

An adaptation changes the function of the unit to a different use.

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