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New IRS Website Guidance on Repair Regulations

In Brief

Several weeks ago, the IRS published on its website a six page Q&A summary of the tangible property regulations . This narrative of Frequently Asked Questions (FAQs) provides a very readable summary of how the new regulations are to be applied. More importantly, it also provides several new insights. The de minimis election can be made even with a greater non-safe harbor expensing policy. And the IRS advises those not desiring to use the small business cut-off method of Rev. Proc. 2015-20 to attach a statement indicating this approach.

De Minimis Safe Harbor Election

The regulations provide a $500 safe harbor amount for most businesses to deduct expenditures that otherwise require capitalization (or $5,000 for businesses with an Applicable Financial Statement) [Reg. 1.263(a)-1(f)]. The FAQs clarify that the $500 or $5,000 limits are not intended as a ceiling on the amount that can be deducted as a business expense. For example, a business may have much larger expenditures for incidental materials and supplies such as fuel, and those expenditures remain fully deductible. The guidance states that "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."

The guidance reminds that the treatment under the de minimis election for tax purposes must be consistent with expensing on the books and records of the business.

A new development in the FAQs relates to the ability to elect the de minimis safe harbor for items costing $500 or less, but also to maintain an internal policy to deduct a greater dollar amount. Previously, most commentators had assumed that an election to adopt the $500 de minimis amount precluded the use of a larger internal expensing policy (e.g., a policy to expense all asset acquisitions under $1,000). In fact, the FAQs advise taxpayers using a larger de minimis policy to still elect the $500 safe harbor in order to protect those smaller expenditures from any IRS exam dispute. This suggests that virtually every business return should add the de minimis expensing election, and do so annually.

The de minimis election is made by attaching a statement to the tax return. The statement must be

titled “Section 1.263(a)-1(f) de minimis safe harbor election” and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the de minimis safe harbor election under §1.263(a)-1(f).

Election to Capitalize Repair and Maintenance Costs

There are circumstances in which taxpayers would rather capitalize repairs for tax purposes. The IRS FAQs remind that Reg. 1.263(a)-3(n) permits an election to capitalize repairs and maintenance as improvements, if these costs are treated as capital expenditures for financial accounting purposes (or as the regulations state “on its books and records regularly used in computing income”). The election is made by attaching a statement to the timely filed original federal tax return stating that the taxpayer is electing to capitalize repair and maintenance costs that have also been capitalized on its books and records. As an annual election, it is not an accounting method and does not need to be applied consistently.

The statement to make this election must be titled “Section 1.263(a)-3(n) Election” and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under §1.263(a)-3(n).

Observation: This election adds another tool for tax preparers to apply during the preparation process when a cash method farmer’s income is lower than desired. Note the requirement, however, of having conforming treatment in the taxpayer’s books and records or other financial accounting.

Small Business Simplified Cut-off Procedure

In mid-February of this year, the IRS issued Rev. Proc. 2015-20, allowing a small business to use a cut-off approach that only applied the new repair regulations for tax years beginning in 2014 and after. A small business for this purpose is defined as one with total assets under $10 million or average annual gross receipts of $10 million or less. Our view has been that using this cut-off approach is generally not advisable: It provides no IRS audit protection for pre-2014 years and it also prevents a taxpayer from claiming a pre-2014 partial disposition loss in 2014. Further, using this cut-off approach prevents later filing of a Form 3115 for any pre-2014 repair regulation transaction or method that requires a change.

The FAQs indicate that a taxpayer who chooses not to utilize the cut-off procedure should consider including a statement in the 2014 tax return that indicates that the business is not applying the simplified rules of Rev. Proc. 2015-20. This is generally advisable because it allows the business at any point in the future to adopt a method change with a Form 3115 to comply with the regulations on a past transaction, whether it be an immediate deduction of an erroneously capitalized item or a favorable four-year spread to reverse an incorrect repair deduction. Under the cut-off approach, these pre-2014 accounting method changes are prohibited.

Here’s a Sample Statement for inclusion in 2014 tax returns:

The taxpayer is a small business within the definitions of Rev. Proc. 2015-20, but the taxpayer is not applying the simplified procedure of Rev. Proc. 2015-20.

Conclusion

The final repair regulations were issued in September of 2013. It’s unfortunate that it took the IRS until March of 2015 to issue these FAQs, although this is perhaps not so detrimental with respect to farm taxpayers. While most farm returns have already been filed for 2014, those returns likely had the de minimis expensing election statement within the return. And amending within the six month relief period of Reg. 301.9100-2(b) to attach a statement indicating that the taxpayer is not following Rev.

Proc. 2015-20 is probably not important for most farm taxpayers. As the IRS FAQs point out, the final repair regulations "synthesize existing case law and prior administrative rules into a framework." Most farm returns likely followed proper methods in the past with respect to repairs and capital expenditures, and do not have non-compliant capitalizations or repair deductions that require a Sec. 481(a) adjustment and the filing of a Form 3115. If a business has been in substantial compliance with court decisions and rulings on repair issues in the past, these FAQs confirm our earlier seminar writings that it is unnecessary to prepare Forms 3115 for every business return.