Accounting Policy for Capitalizing vs. Expensing Tangible Property (Not Including Inventory)

POLICY IS FOR:

______________________________ (hereafter referred to as "the business")

DATE OF ADOPTION:

____

Definitions

Tangible property

Property that can be physically touched. Tangible property includes both tangible personal property and tangible real property. Tangible property does not include intangible property such as logos, copyrights, trademarks, patents, etc.

Tangible personal property

Any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). See Treas. Reg. § 1.48-1(c).

Tangible real property

Land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of the buildings or structures) that are not personal property. See Treas. Reg. § 1.263(a)-2(b)(3) and § 1.48-1(d).

When to Treat Amounts Paid for Tangible Property as "Materials and Supplies"

Amounts paid for materials and supplies will be treated as materials and supplies expense in the business' books if the amounts qualify for treatment as materials and supplies for federal income tax purposes under either Treas. Reg. § 1.162–3 or its future equivalent (default materials and supplies rules) or Treas. Reg. § 1.263(a)-1(f)(1)(ii) or its future equivalent (de minimis safe harbor election for taxpayers without applicable financial statements).

In general, this means that any amounts paid to acquire or produce tangible property will be expensed as materials and supplies in the business' books if it is *not inventory* and if it meets at least one of the following tests:

- The cost of acquiring or producing the property is $500 or less
- The property has an economic useful life of 12 months or less, beginning when the property is used or consumed in the business' operations
- The property is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the business
- The property consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in the business' operations
- There is published guidance from the Treasury or the IRS which permits taxpayers to treat the property as materials and supplies (for example, Rev. Proc. 2002-12 on smallwares and Rev. Proc. 2002-28 on certain inventoriable items)

When to Treat Amounts Paid for Tangible Property as "Repairs"

Amounts paid for repairs and maintenance to tangible property will be treated as repairs expense in the business' books if they qualify for treatment as repairs for federal income tax purposes under Treas. Reg. § 1.162–4 or its future equivalent.

This means that any amounts paid to acquire or produce tangible property will be expensed as repairs in the business' books if the amount is not required to be capitalized for federal income tax purposes. See the section below on improvements for guidance on when to capitalize.

When to Treat Amounts Paid for Tangible Property as "Routine Maintenance"

Amounts paid to maintain tangible property will be treated as maintenance expense in the business' books if the amounts fall under the safe harbor for routine maintenance, per Treas. Reg. § 1.263(a)-3(i) or its future equivalent.

Buildings

For buildings, **routine maintenance** means the recurring activities that the business expects to perform as a result of the business' use of the building to keep the building structure or its building systems in its ordinarily efficient operating condition. It will not include any improvements which increase the value of the building or the building's asset life.

Examples of routine maintenance for buildings include:

- The inspection, cleaning, and testing of the building structure or each building system
- The replacement of damaged or worn parts with comparable and commercially available replacement parts

Routine maintenance may be performed at any time during the useful life of the building structure or building systems. However, activities are routine *only if the business reasonably expects to perform the activities more than once* during the 10-year period beginning at the time the building structure or the building system upon which the routine maintenance is performed is placed in service by the business.

Property other than buildings

For property other than buildings, **routine maintenance** means the recurring activities that the business expects to perform as a result of the business' use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. It will not include any improvements which increase the value of the property or the property's asset life.

Examples of routine maintenance for property other than buildings include:

- The inspection, cleaning, and testing of the unit of property
- The replacement of damaged or worn parts of the unit of property with comparable and commercially available replacement parts

Routine maintenance may be performed any time during the useful life of the unit of property. However, activities are routine *only if, at the time the unit of property is placed in service by the business, the business reasonably expects to perform the activities more than once* during the class life of the unit of property.

In this context, **class life** means the life of the property under the alternative depreciation system, or ADS, rules. Here's a table of the most commonly encountered asset classes and their ADS class lives:

Description of assets included	**ADS Recovery Period (in years)**
Office Furniture, Fixtures, and Equipment Includes furniture and fixtures that are not a structural component of a building. Includes such assets as desks, files, safes, and communications equipment. Does not include communications equipment that is in other classes.	10
Information Systems Includes computers and their peripheral equipment used in administering normal business transactions and the maintenance of business records, their retrieval and analysis.	5
Data Handling Equipment; except Computers Includes only typewriters, calculators, adding and accounting machines, copiers, and duplicating equipment	6
Automobiles, Taxis	5
Light General Purpose Trucks Includes trucks for use over the road (actual weight less than 13,000 pounds)	5
Heavy General Purpose Trucks Includes heavy general purpose trucks, concrete ready mix-trucks, and ore trucks, for use over the road (actual unloaded weight 13,000 pounds or more)	6
Trailers and Trailer-Mounted Containers	6

Tables describing a complete list of ADS class lives, including special class lives for assets in specific industries (especially various manufacturing industries), can be found at IRS.gov.

When to Capitalize Amounts Paid to Acquire or Produce Tangible Property

The business will capitalize all amounts paid to acquire or produce tangible property, not including materials and supplies, in its books. This includes leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures.

Amounts paid to acquire or produce a unit of real or personal property include the invoice price, transaction costs, and costs for work performed prior to the date that the unit of property is placed in service by the business.

The business' accounting policies for tangible property held as inventory are not covered in this document.

When to Capitalize Amounts Paid to Facilitate Acquisition of Tangible Property

The business will capitalize all amounts paid to facilitate the acquisition of tangible property, not including materials and supplies, in its books. This will include, but not necessarily be limited to, the Treasury's list of what it considers **inherently facilitative amounts** [see Treas. Reg. § 1.263(a)-2(f)(2)(ii)].

Inherently facilitative amounts

- Transporting the property (for example, shipping fees and moving costs)
- Securing an appraisal or determining the value or price of property
- Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition
- Application fees, bidding costs, or similar expenses
- Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement)
- Examining and evaluating the title of property
- Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees
- Conveying property between the parties, including sales and transfer taxes, and title registration costs
- Finders' fees or brokers' commissions, including contingency fees
- Architectural, geological, survey, engineering, environmental, or inspection services pertaining to particular properties
- Services provided by a qualified intermediary or other facilitator of an exchange under section 1031

Amounts that are not facilitative

The business will not capitalize in its books any amounts that are not considered facilitative amounts for federal income tax purposes per Treas. Reg. § 1.263(a)-2(f)(2)(iii). These are amounts paid that relate to activities performed *in the process of determining* whether to acquire real property and which real property to acquire. Note this is different from facilitative costs because facilitative costs occur *after* you've decided which property to acquire. Note also that this rule only applies to *real property*.

When to Capitalize Amounts Paid to Improve Tangible Property

The business will capitalize all amounts paid to improve tangible property, not including repairs and maintenance, in its books. The business will treat all **betterments**, **restorations**, and **adaptations to a new or different use** as improvements to tangible property.

Betterments

The company will treat all betterments, as defined in Treas. Reg. § 1.263(a)-3(j) or its future equivalent, as improvements in its books.

This means that any amount paid will be treated as a betterment to a unit of property if it meets at least one of three tests:

- It ameliorates a material condition or defect that either existed prior to the business' acquisition of the unit of property or arose during the production of the unit of property, whether or not the business was aware of the condition or defect at the time of acquisition or production
- It's for a material addition, including a physical enlargement, expansion, extension, or addition of a major component to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property
- It's reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property

Restorations

The business will treat all restorations, as defined in Treas. Reg. § 1.263(a)-3(k) or its future equivalent, as improvements in its books.

This means that any amount paid will be treated as a restoration if it meets at least one of six tests:

- It's for the replacement of a component of a unit of property for which the business has properly deducted a loss for that component, other than a **casualty loss**
- It's for the replacement of a component of a unit of property for which the business has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component
- It's for the restoration of damage to a unit of property for which the business is required to take a basis adjustment as a result of a **casualty loss** or relating to a **casualty event**, subject to certain limits [see Treas. Reg. 1.263(a)-3(k)(4) on these limits]

- It returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use
- It results in the rebuilding of the unit of property to a **like-new condition** after the end of its **class life** (see the section on routine maintenance for an explanation of using class lives)
- Is for the replacement of a part or combination of parts that comprise a **major component or a substantial structural part** of a unit of property

A **casualty loss** in this context is, generally speaking, any loss arising from a **casualty event** such as a fire, storm, shipwreck, or other casualty. This definition doesn't include losses from theft. See Treas. Reg. § 1.165-7.

Like-new condition in this context means a unit of property is brought to the status of new, rebuilt, remanufactured, or a similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications. Generally, a comprehensive maintenance program, even though substantial, does not return a unit of property to a like-new condition. See Treas. Reg. § 1.263(a)-3(k)(5).

A **major component** in this context is a part or combination of parts that performs a discrete and critical function in the operation of the unit of property (does not include incidental components of the property). A **substantial structural part** in this context is a part or combination of parts that comprises a large portion of the physical structure of the unit of property. See Treas. Reg. § 1.263(a)-3(k)(6).

Adaptations to a new or different use

The business will treat all adaptations to a new or different use, as defined in Treas. Reg. § 1.263(a)-3(l) or its future equivalent, as improvements in its books.

A **new or different use** is a use inconsistent with the business' ordinary use of the unit of property at the time originally placed in service by the business.

Conflicts Between This Document and Treasury Regulations

If any explanation of tax accounting rules in this document is in conflict with the applicable treasury regulations, the business' books will follow the accounting rules as described in the treasury regulations. For example, if Treas. Reg. § 1.162–3 is changed such that this document's explanation of its provisions regarding materials and supplies is no longer up to date, the business will follow the provisions of the treasury regulation for its bookkeeping, not this document.