December 27, 2013

Dear Client,

In a previous letter, we discussed a number of the new tax laws that both business and individual taxpayers now need to contend with. There is one other significant law change, relating to materials & supplies and repairs & maintenance, which is addressed below. The way to understand and implement these new rules is to apply the following thought process: 1) Determine what is a Material or a Supply, 2) Establish a repair/capitalization policy by 1/1/14 and expense all items under $500, 3) analyze all purchases over $500 to determine if the expenditure is a Betterment, Restoration or an Adaptation, and finally 4) apply the Routine Maintenance Safe Harbor rules. The following paragraphs provide additional insight into this process.

1. Materials & Supplies. These items can be expensed when consumed if:
   - The item has an acquisition cost of less than $200
   - The item has an economic useful life of less than 12 months, or
   - The item is a fuel, lubricant and similar consumption type item that will be consumed in 12 months or less.

   For items not meeting the above criteria, it may be necessary to inventory or capitalize the item.

2. De minimis Safe Harbor Election & Repair/Capitalization Policy. This election, made on your 2014 tax return, will allow items that cost up to $500 to be deducted in the year paid, rather than consumed. This can apply to materials & supplies as well as to fixed asset purchases. In order to make this election, by 1/1/14, you must have an internal policy for non-tax reasons to expense items up to that $500 amount or expense an item that has an economic useful life of 12 months or less. We have provided a sample policy attached to this email. Please fill this out and keep it as a permanent addition to corporate records by 1/1/14. This policy must be applied consistently to all items during the year.

3. Betterment, Restoration or Adaptation. If the cost of an item exceeds $500, you must then analyze whether the expenditure is a Betterment, Restoration or Adaptation. Expenditures that meet any of these criteria must be capitalized and depreciated.
   - A Betterment: results in a material addition to the property (enlargement, expansion, extension), results in a material increase in capacity, productivity, efficiency, strength, quality of the property or output of the property, or fixes a material condition/defect in the property that existed prior to acquisition.
   - A Restoration: rebuilds the property to like-new condition after the end of its useful life, replaces (not repairs) a part (or combination of parts) that is a major component of the property being repaired that performs a discrete and major function, or returns the property to ordinarily efficient operating condition if it has deteriorated to a state of disrepair and is no longer functioning for intended use (in essence, puts the property back vs. keeps the property in working condition).
• An Adaptation changes the function of the property to a new use.

4. **Routine Maintenance Safe Harbor.** Even if the expenditure exceeds $500, the expenditures are deemed to not improve the property if:
  
  • The taxpayer expects to perform the activity more than once during the useful (ADS) life of the asset
  • The maintenance with comparable replacement parts keeps vs. puts the property in ordinary efficient operating condition AND
  • The need for the maintenance results from the taxpayer’s own use (not a prior owner’s).

If you meet these criteria, the expenditure can be expensed rather than capitalized and depreciated.

Here are some take-aways from the above:

• From a deduction standpoint, it is better to keep property in working order rather than waiting until it breaks down to repair it.

• We strongly recommend that you document on the original purchase invoice, for any item greater than $500 that you are expensing, why you are expensing it (i.e. not a Betterment, Restoration, Adaptation, or that you meet the safe harbor by expecting to perform the maintenance more than once during the property’s useful life). This type of record keeping is easier done contemporaneously rather than trying to recall the rationale for expensing during an audit.

• It is advisable to create additional accounts on your general ledger to break out certain expenses rather than putting everything to Repairs & Maintenance. For example, creating a Garbage Disposal account instead of putting those expenses to Repairs & Maintenance.

Finally, special rules apply to expenditures done to a building. With a policy in place, expenses below $500 should be expensed. For expenditures exceeding $500, the rules require the application of the Betterment, Restoration, Adaptation rules. However, there is a Small Business Building Safe Harbor rule. Under this rule, if gross revenues are less than $10 million and the building’s cost is less than $1 million, and total annual repairs are less than the smaller of $10,000 or 2% of the building’s cost basis, then the repairs are deductible. Also, similar to the Routine Maintenance Safe Harbor above, if the maintenance is done with comparable parts and it is expected that it will have to be done more than once in 10 years, then the expenditures are deductible.

These new rules are fairly complex and require more diligence when these types of costs are incurred. Documenting the rationale for expensing certain items will be important. As questionable expenditures occur during the year, we invite you to call us to discuss these issues.

Sincerely,

ANDALORO, SMITH & KRUEGER, LLP