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NEW RULES FOR SMALL BUSINESSES DEDUCTING REPAIRS

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Almost all businesses incur expenses for tangible property, whether they buy it, produce it or build it, or simply repair and maintain it. Deciding whether these expenditures may be deducted when incurred or must be capitalized and depreciated over time has long been an area of confusion for taxpayers. Over the past decade, the IRS has announced various forms of new Capitalization Rules to provide some clarity in these areas and further to provide some safe harbor rules and exceptions for de minimis expenditures.

New Capitalization Rules

The IRS announced the Final Regulations in 2013, to be effective for the 2014 tax year; however, in an unusual twist, if the taxpayer has not been in compliance with the Capitalization Rules in prior years, then the taxpayer must retroactively adjust its calculation of the expensed and capitalized amounts for the prior years in order to comply with the new Capitalization Rules, and then adjust its 2014 taxable income accordingly. (If the adjustment results in an increase in income, that increase can be spread over four years.) Because of the various capitalization methods that have been used by businesses in dealing with such costs – some permitted methods and some not permitted – the final regulations may affect your business' tax liability for 2014 and beyond.

The final Capitalization Rules can be onerous on businesses that have lots of property, so it is important that your accounting department work with your outside CPA firm to avoid surprises. You may need to file an IRS Form 3115, Application for a Change in Accounting Method, and recalculate the amounts that your business has deducted or capitalized over the past several years.

Luckily, for many small businesses, the IRS recently announced some relief from these Capitalization Rules for certain “qualifying” taxpayers. To be a “qualifying” taxpayer, your business must have the following:

1. Total assets of less than \$10 Million, or (*note – “or”, not “and”*)
2. Average annual gross receipts of \$10 Million or less for the prior three taxable years.

Further, if the taxpayer has more than one separate and distinct trade or business, each trade or business can invoke this relief. This distinction expands the pool of qualifying taxpayers.

Unfortunately, there are many unanswered questions about how to determine “total assets,” “average annual gross receipts” and “separate and distinct trade or business.” Taxpayers will still have to use common sense and best judgment in deciding if they qualify or not. Then, even if your business qualifies for this relief under the Capitalization Rules (which is provided in Rev. Proc. 2015-20, issued February 13, 2015), you will need to decide whether you want to use the relief or not.

Why use relief under Rev. Proc. 2015-20?

If you do not use this relief, then your business must go back to prior tax years and recalculate how expenditures for repairs, improvements, etc. have been deducted or capitalized to make sure that these prior years are in compliance with the new Capitalization Rules. Then, your taxable income in 2014, and perhaps future years, will be adjusted for the changes. For some businesses, this task can be an expensive to perform. Also, the retroactive adjustments must be disclosed on IRS Form 3115 and filed with the IRS, which can also be burdensome.

If you use the relief under Rev. Proc. 2015-20, then becoming compliant with the new Capitalization Rules is much easier. First, you do not need to recalculate the tax treatment for prior years' expenditures as long as you correctly apply the new Capitalization Rules to your 2014 expenditures. While you still have to make sure that your business follows the new Capitalization Rules going forward, you do not need to look at prior years. Secondly, you do not need to file Form 3115, which will also make your accounting folks happy!

In summary, while the decision whether to take advantage of the relief in Rev. Proc. 2015-20 is much more complicated than the scope of this Alert, and the benefits and concerns need to be considered carefully, this new relief for qualifying businesses may make your tax filing for 2014 less onerous. For more information about this Alert please contact a member of **Smith Anderson's Tax group**, *business lawyers who understand taxation*.

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