

WRITTEN CAPITALIZATION POLICIES NOW REQUIRED

While there have been only a few changes in the tax law for 2014, the IRS has revised a number of its regulations regarding the area of fixed assets. The focus of these revised regulations was to clarify the application of the law regarding when to capitalize amounts paid to acquire, produce, or improve property. These new rules are quite extensive, and a full summary of the changes would put most readers to sleep. However, there is one key provision whose time-sensitive nature but relative ease of instituting elicits immediate action.

What could that be?

A safe harbor election for de minimis purchases of property. Admittedly, this doesn't sound very exciting; however, what the IRS has done is create a safe harbor for something most companies do anyway, which is expense all items whose cost is less than a certain dollar threshold. This expensing of property costing less than a certain amount is part of what's called a "capitalization policy." Previously there was no codified rule which would prevent an IRS auditor from forcing a company to capitalize items that it had expensed according to its capitalization policy. With this new de minimis safe harbor the IRS has given us, there is.

What exactly is a capitalization policy?

A capitalization policy is a rule, or set of rules, used by companies to determine if a particular transaction should be capitalized and depreciated, or expensed outright. Capitalization policies can be very long winded and detailed, describing different rules for different types of property, or they can be very concise with a simple statement of a dollar threshold where a company will not consider whether the item should be capitalized.

In initial drafts of the regulations that the IRS issued in 2011, they were looking to establish a mathematical formula to determine the de minimis threshold on a taxpayer-by-taxpayer basis. These initial rules used a threshold of 0.1% of gross receipts or 2% of financial statement depreciation. Through the long comment process with the public and other stakeholders, the IRS rejected these mathematical thresholds in the final regulations and in their stead is a far simpler, but potentially less advantageous, de minimis threshold which is: \$500 for most taxpayers or \$5,000 for certain taxpayers who have an "Acceptable Financial Statement" (which, because the IRS loves a good acronym, termed it an AFS).

What is an AFS?

In order of precedence:

1. A financial statement required to be filed with the SEC
2. An independently audited financial statement used for credit reporting, reporting to owners or any other substantial nontax purpose
3. A financial statement which is not a tax return that was required to be provided to a state or federal agency which is not the IRS or SEC.

So this means that for the majority of taxpayers, the \$500 safe harbor threshold applies.

What if you don't agree with the \$500/\$5,000 amount?

The regulations allow the IRS to come to an agreement with the taxpayer on a threshold greater than the \$500/\$5,000 thresholds. For example, if the \$500 safe harbor threshold applies to you but you believe your threshold should be higher, you can institute a capitalization policy with a higher threshold, for example \$2,000. If under audit, the auditor disagrees with this threshold, only the items costing more than the \$500 applicable safe harbor can be questioned. The IRS has not provided guidance on how auditors are to determine if the taxpayer's threshold clearly reflects income but states that it is up to the taxpayer to prove that they are not understating income via their capitalization policy.

What goes into a piece of property's "cost"?

The IRS's rules are very detailed on this topic; however, generally speaking, any additional costs on the invoice (i.e. shipping and handling, sales taxes) should be allocated to the cost of the purchased items in some reasonable manner.

What you should do

At a minimum, you need a written capitalization policy. This policy should include at least the following:

- An effective date of January 1, 2014
- A statement that all units of property whose economic useful life is shorter than 12 months are expensed
- A statement that all units of property whose cost is less than your threshold of \$500/\$5,000 are also expensed

A simple statement such as the following will suffice for the IRS requirement regarding this de minimis election:

Effective January 1, 2014, the ABC Company is instituting a capitalization policy for financial statement and tax purposes that all units of property whose economic useful life is shorter than 12 months OR costs less than \$500 will be treated as a current expense.

This policy needs to be the same for both book and tax purposes in order for this safe harbor election to be allowed.

Bottom line is that every business needs to have a written capitalization policy by January 1, 2014, and keep it someplace safe, such as a file where you keep documents like corporate minutes, and organization documents. Consider incorporating the 2014 policy in your written corporate minutes for December 31, 2013. If you are unable to provide this policy under audit, the election to take the safe harbor is invalid.

If you have any questions regarding this or any other changes in this year's tax law, please contact us.