Chapter 2: Small Business Issues

Please note. Corrections were made to this workbook through January of 2017. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

EMPLOYEE REIMBURSEMENT PLANS

U.S. tax law allows taxpayers to deduct business expenses generally defined by the Code as the "ordinary and necessary" expenses incurred in carrying on a trade or business.[1] Eligible nonemployee business expenses are deductible as part of the calculation of the taxpayer's adjusted gross income (AGI).[2] Unreimbursed employee business expenses, however, are deductible from income only to the extent that, when combined with other miscellaneous itemized deductions, they total more than 2% of the taxpayer's AGI.[3] The amount of the total miscellaneous itemized deductions that exceeds the 2% floor is entered on line 27 of Schedule A, *Itemized Deductions.*

In recognition of the impact that unreimbursed expenses have on employees, employers often reimburse employees or provide them with allowances to cover business expenses. As long as such a reimbursement or allowance is made under an **accountable plan,** the reimbursement is not includable in the employee's wages and they do not pay tax on this amount.[4] If the reimbursement paid to the employee by the employer does not meet the requirements of an accountable plan, it is deemed to have been paid under a **nonaccountable plan.** A reimbursement provided by an employer to an employee under a nonaccountable plan is includable as wages on the employee's Form W-2, *Wage and Tax Statement.* The employee can then deduct eligible expenses as unreimbursed business expenses.

Depending on the facts and circumstances of the employer–employee payment arrangement, some reimbursements or allowances from an employer to an employee may be made under an accountable plan, while other payments between the same parties may be made under a nonaccountable plan.[5]

Observation. If an employee fails to submit expenses to their employer according to the employer's reimbursement rules and therefore does not receive reimbursement, the employee is not allowed a tax deduction for the unreimbursed amount.

1. IRC §162(a).
2. IRC §62(a)(1).
3. IRC §67(a).
4. Treas. Reg. §1.62-2(c)(4).
5. Treas. Reg. §§1.62-2(c)(1), (d)(2).

ACCOUNTABLE PLAN

An arrangement under which an employer reimburses an employee for expenses or provides an advance or allowance to the employee to cover the expenses is an accountable plan if it meets **all** the following requirements.[6]

1. **The expenses have a business connection,** which means the employee incurred the expenses in connection with the performance of services as an employee of the employer and the expenses are allowable as deductions.
2. **The employee adequately substantiates** the expenses by accounting to the employer for them within a **reasonable period of time.**
3. **The employee returns to the employer any excess reimbursement,** advance, or allowance within a **reasonable period of time.**

The determination of whether expenses are paid under an accountable plan is determined on an employee-by-employee basis.

Adequate Substantiation

Requirement 2 states that an employee must adequately substantiate the expenses paid by their employer through an accountable plan. The following expense categories must be substantiated.[7]

- Travel expenses while away from home, including meals and lodging
- Expenses associated with business entertainment, amusement, or recreation or incurred for a facility used in connection with these types of activities
- Business gifts (The amount deductible by the employer may be limited.)
- Certain "listed property," including passenger automobiles[8]

Substantiation for travel, entertainment, and gift expenses must include an **adequate accounting** and other evidence to prove the following.[9]

- The amount of the expense or gift
- The time and place of the travel or entertainment, the use of the facility, or the date and description of the gift
- The business purpose of the expense or gift
- The business relationship to the employee of the persons entertained or receiving the gift

The regulations specify that an adequate accounting means that the employee must submit to the employer an account book, diary, log, statement of expense, trip sheet, or similar record the employee has maintained. Such account should include the information as to each element of an expenditure recorded at or near the time of the expenditure.[10] In addition, for all lodging expenses incurred while traveling away from home and for any other expenditure of $75 or more (with the exception of a transportation charge when documentation may not be readily available), the employee must also submit to the employer documentary evidence such as receipts, paid bills, or similar evidence sufficient to support the expenditure.[11]

> **Note.** For lodging, the receipt must include name, location, date, and separate amounts for lodging, meals, telephone, and other expenses.

6. Treas. Reg. §§1.62-2(d), (e), (f).
7. IRC §274(d).
8. Listed property is governed by alternative methods for substantiation. See Temp. Treas. Reg. §1.274-6T.
9. IRC §274(d).
10. Treas. Reg. §1.274-5(f)(4).
11. Treas. Reg. §1.274-5(c)(2)(iii).

The following table provides guidelines on what constitutes an **adequate accounting** by an employee.[12]

	Amount	Time	Place or Description	Business Purpose or Relationship
Travel	Costs for each separate expense: lodging, meals, and incidental expenses (which may be grouped into categories such as "tips")	Days departing and returning and number of days spent on business for each trip	Name of city departing from and arriving to	Business purpose for trip
Transportation	Cost of each separate expense, including mileage for each business use	Date of expense	Business destination	Business purpose for expense
Gifts	Cost of gift	Date gift given	Description of gift	Business reason for gift, including name, title, and business relationship of the recipient
Entertainment	Cost of each separate expense	Date of entertainment	Address of entertainment venue, as well as a description of type of entertainment	Business reason for entertainment, including any business discussions taking place and names, titles, and business relationships of attendees

Deemed Substantiation. An employer can pay a per diem allowance to an employee instead of reimbursing the employee's actual travel expenses. The amount of the expenses paid for each calendar day is **deemed substantiated** if it does not exceed the lesser of the per diem allowance for that day or the amount computed at the federal per diem rate. If the employee provides an adequate accounting to the employer (as described earlier), they are not required to include the amount deemed substantiated in their gross income. The amount deemed substantiated is not reported as wages on the employee's Form W-2 and is exempt from withholding and payment of employment taxes.[13]

Note. The federal per diem rates are effective October 1 of each fiscal year. These rates can be found at **uofi.tax/16b2x1** [www.gsa.gov/perdiem]. Employers must set a policy for reimbursing at the per diem rate. Employers may choose to reimburse at the federal rate in effect on the date the expenses were incurred (i.e., the rate in effect January 1 through September 30, or October 1 through December 31) or they may choose to reimburse at the rate in effect on January 1 of that tax year for the entire tax year.[14]

12. Treas. Reg. §1.62-2(e).

13. Rev. Proc. 2011-47, 2011-42 IRB 520.

14. Rev. Proc. 96-28, 1996-1 CB 686, section 4(2).

For a business trip in which the employee uses a personal vehicle, the employee may receive a per diem advance, allowance, or reimbursement based on federal mileage rates in lieu of substantiating actual costs.[15] For 2016, the federal mileage rate is $0.54 per mile for business miles driven.[16] Use of the per diem method does not relieve the employee of the requirement to substantiate the business mileage, time, destination, and business purpose of each use of a personal vehicle.

If the actual business expenses exceed the amount of the per diem, the employer may pay the employee, under an accountable plan, a reimbursement equal to the actual expenses. The actual expenses must be substantiated.

Generally, if the amount of an employee reimbursement under an accountable plan is less than the total amount of the business expenses paid or incurred by the employee and the employer does not reimburse the employee for the excess costs, it may be necessary to allocate the reimbursement. An allocation is necessary when an employer:[17]

- Pays the employee a single amount that covers meals and/or entertainment, as well as other expenses; **and**
- Does not clearly identify how much is for deductible meals and/or entertainment.

Example 1. Marta received an allowance of $1,000 from her employer for business travel under an accountable plan. The employer did not specify how much of the allowance was for meals, entertainment, and lodging. On her business trip, Marta spent $1,000 for lodging expenses and $500 for meals and entertainment.

Because Marta spent more than what was paid to her under the accountable plan and because her employer did not specify how much of the allowance was for meals and entertainment, Marta must allocate the reimbursement. Her allocation worksheet follows.[18]

1	Employer reimbursements not reported in box 1 of Form W-2		$1,000	$1,000
2	Total amount of expenses Marta incurred	$1,500		
3	Of amount on line 2, amount attributable to meals and entertainment	500		
4	Percentage of total expenses attributable to meals and entertainment (line 3 ÷ line 2)	.333	× .333	
5	Amount of the employer reimbursement attributable to meals and entertainment (line 1 × line 4)		$ 333	(333)
	Amount of the reimbursement attributable to lodging expenses (line 1 − line 5)			$ 667

15. Treas. Reg. §1.274-5(g)(2)(ii).

16. *2016 Standard Mileage Rates for Business, Medical and Moving Announced.* Dec. 17, 2015. IRS. [www.irs.gov/uac/Newsroom/2016-Standard-Mileage-Rates-for-Business-Medical-and-Moving-Announced] Accessed on Apr. 28, 2016.

17. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses.*

18. Ibid.

Reasonable Period of Time

The regulations provide two "safe harbors" for determining when excess reimbursements, advances, or allowances are returned under an accountable plan within a **reasonable period of time.**[19]

1. **Fixed date method.** The arrangement is treated as occurring within a reasonable period of time if:
   - The advance is made within 30 days of when an expense is paid or incurred,
   - The employee adequately accounts for expenses within 60 days after the expenses were paid or incurred, or
   - The employee returns any excess reimbursement within 120 days after the expenses were paid or incurred.
2. **Periodic statement method.** The employer provides a quarterly (or more frequent) statement, and the employee adequately accounts for outstanding advances or returns excessive advances within 120 days of receiving the employer's statement.

Failure to Meet Requirements

If an advance or reimbursement fails to meet all the requirements for an accountable plan, it is deemed to have been paid under a nonaccountable plan and is consequently includable in the employee's income. Several common situations trigger this result.

- **The employee fails to adequately account for expenses within a reasonable period of time.** If an employee fails to adequately account for expenses and provide their employer with the required documentation within a reasonable period of time, the entire advance or reimbursement must be treated as having been paid under a nonaccountable plan. The advance or reimbursement is then subject to withholding and payment of employment taxes no later than the first payroll period following the expiration of the reasonable period.[20] The employee is required to report that income even if the employer fails to include it on the employee's Form W-2.
- **The employee fails to return an excess advance or reimbursement within a reasonable period of time.** When an employee fails to return an excess advance or reimbursement to the employer within a reasonable period of time, the excess advance or reimbursement is treated as paid under a nonaccountable plan. An excess reimbursement or advance is any amount the employee received from the employer that exceeds the business-related expenses that the employee adequately accounted for to the employer. This excess amount is subject to withholding and payment of employment taxes no later than the first payroll period following the expiration of the reasonable period.[21]
- **The employee receives an advance or reimbursement for nondeductible expenses.** If an employer advances an amount or reimburses an employee for a nondeductible expense, that amount is treated as having been paid under a nonaccountable plan.

19. Treas. Reg. §1.62-2(g)(2).

20. Treas. Reg. §1.62-2(h)(2).

21. Ibid.

Example 2. Craftt Foods (Craftt) provided its employee Darnell with a $2,000 travel advance to fly to Hawaii for a business trip. Included in the advance was $1,000 to pay the airfare for Darnell's wife, Sage.

The $1,000 attributable to the employee's airfare satisfies the requirements for payments under an accountable plan. The $1,000 attributable to Sage's airfare is a nondeductible expense and is treated as having been paid under a nonaccountable plan. Therefore, Craftt includes the $1,000 paid for Sage's airfare in boxes 1, 3, and 5 of Darnell's Form W-2. The amount Darnell received for his own airfare under the accountable plan is included in box 12 of his Form W-2, with a code "L," which signifies that the $1,000 is a nontaxable, substantiated business expense.

> **Note.** Darnell must include a Form 2106, *Employee Business Expenses,* or 2106-EZ, *Unreimbursed Employee Business Expenses,* with his tax return. These forms are discussed later in this section.

- **The employee receives a per diem allowance that is more than the federal rate.** If an employee receives a per diem advance at a rate higher than the applicable federal rate, the portion of the advance that is greater than the federal rate is considered paid under a nonaccountable plan. It should be included as income in boxes 1, 3, and 5 of the employee's Form W-2. The employee is required to report that income even if the employer fails to include it on the employee's Form W-2.

Reimbursement Less Than Actual Expenses

If an employer's accountable plan does not adequately reimburse the employee for the full amount of deductible business expenses, the employee may claim a deduction for the unreimbursed expenses by filing Form 2106 or Form 2106-EZ.

Example 3. Frugal Company (Frugal) provided Edward with a per diem advance of $75 per day for a 5-day business trip to San Francisco. Edward's substantiated business expenses actually totaled $300 per day, but the company did not pay him the difference.

Frugal includes $375 ($75 per day × 5 days) in box 12 of Edward's Form W-2. This amount is considered paid under an accountable plan. As such, Edward is not required to pay taxes on this amount and does not claim a deduction for the expenses covered by this amount.

Edward may claim the remaining $1,125 (($300 actual expenses per day × 5 days) − $375 advance) of substantiated business expenses as unreimbursed employee business expenses on Form 2106. However, he may deduct only 50% of the actual costs of his meals and entertainment. He can report this total as a miscellaneous itemized deduction on line 21 of his Schedule A. This amount is subject to the 2% floor.

NONACCOUNTABLE PLAN

A **nonaccountable plan** is any employer–employee expense reimbursement arrangement that does not meet the three statutory requirements for an accountable plan (described earlier). It is the **employer's decision** whether to reimburse an employee under an accountable plan or a nonaccountable plan. The employee cannot transform a nonaccountable plan to an accountable plan by substantiating their expenses and returning any excessive reimbursement to the employer.

When an employer reimburses or advances expenses to an employee under a nonaccountable plan, the amount of the reimbursement or advance is reported on the employee's Form W-2 as income. The amount is subject to withholding and employment taxes.[22]

The employee may deduct a nonaccountable plan reimbursement that is included in their gross income as unreimbursed employee business expenses.

> **Note**. For details on the procedures an employee should follow for substantiating and reporting employee business expenses, see the 2014 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 4: Special Taxpayers. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

22. Treas. Reg. §1.62-2(c)(5).

EMPLOYER IDENTIFICATION NUMBER

An employer identification number (EIN) is a 9-digit number that the IRS assigns to identify the tax accounts of employers and certain other entities that have no employees. The IRS uses EINs to identify taxpayers that are required to file various business tax returns.

> **Caution.** An EIN cannot be used in place of a social security number.

A taxpayer who answers "yes" to any of the following questions is required to obtain an EIN. [23]

1. Does the business have employees?
2. Is the business operated as a corporation or a partnership?
3. Does the business file any of these tax returns: employment, excise, or alcohol, tobacco, and firearms?
4. Does the employer withhold taxes on income, other than wages, paid to a nonresident alien?
5. Does the business have a Keogh plan?
6. Is the business involved with any of the following types of organizations?
    - Trusts, except certain grantor-owned revocable trusts, IRAs, exempt-organization business income tax returns
    - Estates
    - Real estate mortgage investment conduits
    - Nonprofit organizations
    - Farmers' cooperatives
    - Plan administrators

23. *Do You Need an EIN?* May 6, 2016. IRS. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Do-You-Need-an-EIN] Accessed on May 9, 2016.

A taxpayer can obtain an EIN using any of the following methods.[24]

- Apply online at **uofi.tax/16b2x2** [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-(EIN)-Online]. Applying online is free and provides an immediate EIN for the taxpayer.

> **Caution.** Before the application is submitted, the review page should be printed. Once the form is submitted, it cannot be printed later.

- Complete a Form SS-4, *Application for Employer Identification Number,* and mail it to one of the following addresses. The IRS processes a paper copy of the form and issues an EIN within four weeks.[25]
  - If the taxpayer's principal business, office, or agency is located in one of the 50 states or the District of Columbia, the Form SS-4 should be mailed to the following address.

    Internal Revenue Service
    Attn: EIN Operation
    Cincinnati, OH 45999

  - If the taxpayer has no principal place of business or principal office or agency in any state, the form should be mailed to the following address.

    Internal Revenue Service
    Attn: EIN International Operation
    Cincinnati, OH 45999

- Fax the completed Form SS-4 to one of the following telephone numbers. If the taxpayer's fax number is provided, a fax with the EIN will be sent back within four business days.[26]
  - If the taxpayer's principal business, office, or agency is located in one of the 50 states or the District of Columbia, the fax should be sent to **859-669-5760.**
  - If the taxpayer has no principal place of business or principal office or agency in any state, the fax should be sent to **859-669-5987.**

A taxpayer is limited to one EIN application per responsible party per day.[27] A **responsible party** is an individual or entity that controls, manages, or directs the applicant entity and the disposition of its funds and assets.[28] This limitation is applicable to all requests for EINs, whether made online or by fax or mail.[29]

Generally, a business may require a **new** EIN if it changes its entity or ownership structure. The circumstances that require a business to apply for a new EIN depend on the business's entity type.

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24. *How to Apply for an EIN.* May 13, 2016. IRS. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/How-to-Apply-for-an-EIN] Accessed on Jun. 6, 2016.

25. *Where to File Your Taxes.* Dec. 3, 2015. IRS. [www.irs.gov/uac/Where-to-File-Your-Taxes--(for-Form-SS-4)] Accessed on May 10, 2016.

26. Ibid.

27. *How to Apply for an EIN.* May 13, 2016. IRS. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/How-to-Apply-for-an-EIN] Accessed on May 23, 2016.

28. *Responsible Parties and Nominees.* Sep. 2, 2015. IRS. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Responsible-Parties-and-Nominees] Accessed on May 11, 2016.

29. *How to Apply for an EIN.* May 13, 2016. IRS. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/How-to-Apply-for-an-EIN] Accessed on Apr. 29, 2016.

ENTITY TYPES

Whether a business needs an EIN depends on how the business is organized. This section discusses when the following entity types need to apply for a **new** EIN.

- Sole proprietorship
- Limited liability company (LLC)
- Corporation
- Partnership
- Estate
- Trust

Sole Proprietorship[30]

A sole proprietorship is an unincorporated business that is owned by one individual. The business does not exist as separate from the owner, and its liabilities are the owner's liabilities.

A sole proprietorship **does not need** a new EIN under the following circumstances.

- The name of the business changes.
- The business changes or adds locations.
- The proprietorship operates multiple businesses (including stores, plants, enterprises, or branches of the entity).

A sole proprietorship **must obtain** a new EIN if any of the following apply.

- The business incorporates.
- A business with employees establishes a single-member LLC (disregarded entity)
- The owner adds partners and operates the business as a partnership.
- The business establishes a pension, profit-sharing, or retirement plan.
- The business files for bankruptcy under Chapter 7 (liquidation) or Chapter 11 (reorganization).

Limited Liability Company

An LLC is a business entity created under state law. An LLC can be treated as a partnership, corporation, or disregarded entity for federal income tax purposes.

An LLC owned by one member is treated as a disregarded entity (sole proprietorship) for federal income tax purposes. A single-member LLC classified as a disregarded entity may need to obtain an EIN for the LLC. A sole proprietor who conducts business as an LLC needs a separate EIN for the LLC **if they are required to file employment, information, or excise tax returns.**[31] The LLC also needs a separate EIN if it will receive Forms 1099 under the LLC's name.

Generally, an LLC with two or more owners can elect to be treated as a partnership or a corporation. A business that qualifies under IRC §1362(a) can be taxed as an S corporation.[32]

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30. IRS Pub. 1635, *Employer Identification Number.*

31. IRS Pub. 3402, *Taxation of Limited Liability Companies*; IRS Pub. 1635, *Employer Identification Number.*

32. IRS Pub. 1635, *Employer Identification Number.*

An LLC **does not need** a new EIN under the following circumstances.[33]

- The LLC has no employees or excise tax liability and reports income tax as a branch or division of a corporation or other entity.
- An existing partnership converts to an LLC classified as a partnership.
- The LLC name or location changes.
- An LLC with an existing EIN chooses to be taxed as a C corporation or an S corporation.
- A new LLC with one owner is formed, does not elect to be taxed as a C corporation or an S corporation, and has no employees or excise tax liability.

An LLC **must obtain** a new EIN if any of the following apply.[34]

- A new LLC with more than one owner is formed.
- A new LLC with one owner is formed and elects to be taxed as a C corporation or an S corporation.
- A new LLC with one owner is formed (a disregarded entity) and has an excise tax filing requirement for tax periods beginning on or after January 1, 2008, or an employment tax filing requirement for wages paid on or after January 1, 2009.

Example 4. Lonely Lonnie started a dating website called Desperate Daters and operated it as a sole proprietorship. The website became a huge success, but Lonnie was concerned that he would be held personally responsible if any of the daters had a poor experience. Lonnie also wanted to protect the significant personal wealth he had amassed by never paying for dates or purchasing Valentine's or anniversary presents.

Lonnie decided to reorganize Desperate Daters as an LLC treated as a C corporation to protect his personal assets. As a sole proprietorship, Desperate Daters did not need an EIN because the income and expenses were reported on Lonnie's Form 1040, *U.S. Individual Income Tax Return*, and there were no payroll or excise taxes. However, as an LLC treated as a C corporation, Desperate Daters is required to have an EIN.

Example 5. Valerie is a small-town veterinarian who works out of a clinic located on her farm. She is the only member of her practice, Eastern Illinois Equine and Invertebrate Organisms, LLC (EIEIO). As news spreads of Valerie's good work, EIEIO has more business than she can manage by herself. Valerie decides to offer her cousin Vinny a 35% ownership role in EIEIO in exchange for his services.

Once Vinny becomes a member, EIEIO can no longer be a single-member LLC. Valerie and Vinny decide that EIEIO will become an LLC organized as a partnership. EIEIO needs a new EIN because it now has more than one owner.

Series LLC.[35] A few states, including Illinois, permit the organization of a series LLC. A series LLC has the ability to create separate "series" or "cells" within an LLC that have their own interests, liabilities, and members. One series is not responsible for the liabilities of any of the other series.

In 2010, the IRS issued a proposed regulation that would treat each member in a series as a separate legal entity for federal income tax purposes, regardless of how the state treats a series LLC.[36] Accordingly, members in a series should obtain a unique EIN according to the applicable rules.

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33. *Do You Need a New EIN?* May 6, 2016. IRS. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Do-You-Need-a-New-EIN] Accessed on May 11, 2016.

34. Ibid.

35. *A Guide for Organizing Domestic Limited Liability Companies.* Oct. 2014. Illinois Secretary of State. [www.cyberdriveillinois.com/publications/pdf_publications/c334.pdf] Accessed on May 4, 2016.

36. Prop. Treas. Reg. §301.7701-1(a)(5)(iii)-(iv).

Corporation[37]

A corporation is a legal entity consisting of people or groups of people who become shareholders. The entity is separate and distinct from its members.

A corporation **does not need** a new EIN under the following circumstances.

- An activity is treated as a separate division of a corporation.
- A corporation declares bankruptcy. (However, if a liquidating trust is established for a corporation in bankruptcy, the trust needs an EIN.)
- The name of the business changes.
- The business changes or adds locations.
- The business elects to be taxed as an S corporation.
- The business identity, form, or place of organization changes following a corporate reorganization.
- Any portion of the corporation stock is sold.
- An entity is the surviving corporation after a corporate merger and uses its existing EIN.

Example 6. Sliding Scale Rulers Inc. (Sliding) noticed a dramatic decrease in sales over the last three years. Sliding's closest competitor, One Inch At a Time Rulers Inc. also experienced declining sales. The two companies agree to merge, and Sliding is the surviving corporation.

To promote comradery, the companies agree to a new name: Measure of Success Rulers Inc. (Measure). Measure will continue using Sliding's EIN and **does not** need to apply for a new EIN.

A corporation **must obtain** a new EIN if any of the following apply.

- A subsidiary of a corporation currently uses the parent's corporate EIN.
- An entity becomes a subsidiary of a corporation.
- A corporation becomes a partnership or sole proprietorship.
- A new corporation is created after a consolidation.
- The business receives a new corporate charter.

Partnership[38]

A partnership is an entity that joins two or more persons to carry on a trade or business.

A partnership **does not need** a new EIN under the following circumstances.

- The partnership declares bankruptcy. (However, if a liquidating trust is established for the partnership in bankruptcy, the trust must obtain an EIN.)
- The partnership's name changes.
- The partnership changes or adds locations.
- The partnership has a technical termination under IRC §708(b)(1)(B). Under §708(b)(1)(B), a partnership is considered terminated if within 12 months there is a sale or exchange of at least 50% of the total interest in partnership capital and profits to another partner. If the purchaser and remaining partners immediately contribute the properties to a new partnership, they can retain the old partnership EIN.

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37. IRS Pub. 1635, *Employer Identification Number.*
38. Ibid.

A partnership **must obtain** a new EIN if any of the following apply.

- The partnership incorporates.
- One partner takes over and operates as a sole proprietorship.
- The partnership is terminated (but no part of the partnership's business, financial operation, or venture continues to be carried on by any of its partners in a partnership), and a new partnership is started.

Estate[39]

An estate is a legal entity created as the result of a person's death and is a separate legal entity for federal tax purposes.

An estate **does not need** to obtain a new EIN for changes in its administrator, personal representative, executor, or estate beneficiaries.

An estate **must obtain** a new EIN if either of the following apply.

- A trust is created with estate funds. Such a trust is not just a continuation of the estate.
- The estate operates a business after the owner's death.

Example 7. Brandon died, and his estate consisted of his house, art, stocks, and cash. The estate has one beneficiary, Amy, who is Brandon's daughter. Amy and Brandon had a contentious relationship, and Amy does not want to keep any of her father's possessions. She sold all of the assets in the estate and used the proceeds to establish Animosity Trust for the benefit of her daughter. Animosity Trust needs a new EIN because it is not a continuation of the estate.

Trust[40]

A trust is an arrangement through which trustees take title to property to protect or conserve it for the beneficiaries.

A trust **does not need** a new EIN if:

- The trustee changes, or
- The grantor or beneficiary changes their name or address.

> **Note.** Even though the IRS may not require a new EIN, a new EIN may be required by the Farm Service Agency in certain situations.

A trust **must obtain** a new EIN if any of the following occur.

- A trust changes to an estate.
- A living (inter vivos) trust changes to a testamentary trust.
- A revocable trust changes to an irrevocable trust.

> **Note.** For more information on trusts, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Trust Accounting and Taxation; and the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Trust and Estate Taxation.

39. Ibid.

40. Ibid.

Grantor Trust.[41] A grantor trust is a trust in which the grantor (creator of the trust) retains control over the assets and/or benefits from the assets. The grantor is taxed on some or all of the trust income. A grantor with multiple trusts must have a separate EIN for each trust. However, a single trust with several beneficiaries only needs one EIN.

Note. For more information about grantor trusts, see pages 124–126 of the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Trust Accounting and Taxation.

Example 8. Gerald, who is a generous father and grandfather, meets with his accountant and does some estate planning. He establishes one grantor trust for his two sons, Zack and Tyler, and four separate grantor trusts for his four granddaughters. The trust for his sons lists both Zack and Tyler as beneficiaries; this trust requires only one EIN. Four separate EINs are required, however, for the four trusts established in Gerald's granddaughters' names.

BANKING REQUIREMENTS[42]

A business that does not require an EIN for business purposes may require an EIN for banking purposes only. A bank requires an identification number (social security number or EIN) to open an account. An entity that applies for an EIN only for banking purposes must specify that purpose on Form SS-4.

Example 9. The Pin Ups is a bowling league located in St. Louis. It has no federal income tax filing requirement, no employees, and thus no requirement to obtain an EIN. The Pin Ups collects dues, writes checks for uniforms, and issues refunds — all of which are facilitated by having a checking account with a local bank. The bank requires an EIN to establish an account. The Pin Ups mailed the following Form SS-4 to the IRS.

Form **SS-4** (Rev. January 2010) Department of the Treasury Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.)

▶ See separate instructions for each line. ▶ Keep a copy for your records.

OMB No. 1545-0003

EIN

Type or print clearly.

1 Legal name of entity (or individual) for whom the EIN is being requested **The Pin Ups**	
2 Trade name of business (if different from name on line 1)	3 Executor, administrator, trustee, "care of" name **John Spare**
4a Mailing address (room, apt., suite no. and street, or P.O. box) **300 Perfect Game Road**	5a Street address (if different) (Do not enter a P.O. box.)
4b City, state, and ZIP code (if foreign, see instructions) **Saint Louis, MO 63128**	5b City, state, and ZIP code (if foreign, see instructions)
6 County and state where principal business is located **Saint Louis County, MO**	
7a Name of responsible party **John Spare**	7b SSN, ITIN, or EIN **101-01-0101**
8a Is this application for a limited liability company (LLC) (or a foreign equivalent)? . . . . ☐ Yes ☒ No	8b If 8a is "Yes," enter the number of LLC members . . . . ▶

8c If 8a is "Yes," was the LLC organized in the United States? . . . . ☐ Yes ☐ No

9a **Type of entity** (check only one box). **Caution.** If 8a is "Yes," see the instructions for the correct box to check.

☐ Sole proprietor (SSN)	☐ Estate (SSN of decedent)
☐ Partnership	☐ Plan administrator (TIN)
☐ Corporation (enter form number to be filed) ▶	☐ Trust (TIN of grantor)
☐ Personal service corporation	☐ National Guard ☐ State/local government
☐ Church or church-controlled organization	☐ Farmers' cooperative ☐ Federal government/military
☒ Other nonprofit organization (specify) ▶ **Bowling League**	☐ REMIC ☐ Indian tribal governments/enterprises
☐ Other (specify) ▶	Group Exemption Number (GEN) if any ▶

9b If a corporation, name the state or foreign country (if applicable) where incorporated	State	Foreign country

10 **Reason for applying** (check only one box) ☒ Banking purpose (specify purpose) ▶ **Bowling league dues**

☐ Started new business (specify type) ▶ ☐ Changed type of organization (specify new type) ▶

41. Ibid.

42. Instructions for Form SS-4.

CAPITALIZATION VS. REPAIR UPDATE

To determine whether to write off certain business expenses or depreciate them often requires a critical analysis of facts and circumstances. IRC §162(a) allows taxpayers engaged in a trade or business to deduct "ordinary and necessary" business expenses. However, IRC §263(a) disallows deductions for buildings and most tangible property improvements (i.e., betterments, adaptations, and restorations). Instead of deducting these costs, taxpayers must capitalize §263(a) enhancements and recover these investments through depreciation.

The murky area between "ordinary and necessary" expenses and property improvements often proves challenging — even for tax professionals. For instance, is replacing a window in a rental unit an ordinary and necessary business expense or an improvement to the rental unit?

After nearly a decade of research, public input, and revision, on September 13, 2013, the IRS finalized the tangible property regulations with the issuance of Treasury Decision (TD) 9636.[43] With these new regulations, the IRS attempted to provide guidance on the distinction between §§162(a) and 263(a) by consolidating case law and other administrative rulings. The IRS also removed some of the ambiguity in the Code by creating certain safe harbors for taxpayers.

The new regulations went into effect for tax years beginning on or after January 1, 2014. However, the application of TD 9636 still leaves many perplexed. These final regulations shed light into the murkiness, but they do not clarify every position. Facts-and-circumstances tests still require a reasonable application of the Code and the regulations in the analysis of a taxpayer's unique situation.

> **Caution.** Although capitalization may not be required under §263, costs may still be subject to uniform capitalization under §263A.

The final tangible property regulations affect an estimated 4 million taxpayers each year.[44] In addition to business entities, everyone who files a Schedule C, *Profit or Loss From Business*; Schedule F, *Profit or Loss From Farming;* and/or Schedule E, *Supplemental Income and Loss*, is subject to TD 9636.

Like the Code definition of income (all income is taxable unless otherwise excepted), the final tangible property regulations take the approach that all noninventory tangible property expenditures must be capitalized (i.e., generally recovered through depreciation) unless an exception applies. Exceptions include qualifying materials and supplies[45] and repairs and maintenance.[46] These exceptions are not required to be capitalized and may be deducted on the taxpayer's return. The timing of the deduction varies according to the type of item and how the taxpayer treats the item for business purposes.

Through special elections and safe harbors, the final regulations allow taxpayers to deduct certain items that otherwise must be capitalized and to capitalize certain items that otherwise could be deducted.

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43. TD 9636, 2013-43 IRB 331.

44. Ibid.

45. Treas. Reg. §1.162-3.

46. Treas. Reg. §1.162-4.

This chapter reviews and further explores the final regulations by following tangible property expenses from initial purchase through disposition. To illustrate the effect these regulations have on those engaged in a trade or business, three different taxpayers are used as examples throughout this chapter.

1. The first taxpayer is Woo Kim. Ms. Kim was widowed in 2015 and has three children under the age of 17 living with her. She purchased an existing day spa business in 2016. Woo will use the qualifying widow (QW) with dependent child filing status for 2016, and she falls in the lower income tax range.
2. The second taxpayer is Will Andrews. Mr. Andrews is an insurance agent and has been in business for 10 years. Mr. Andrews and his wife have three children living at home. Two are under age 17 and one is a junior in college. The Andrews will use the married filing jointly (MFJ) status for 2016 and fall in a middle income tax range.
3. The third taxpayer is Ken Wilson. Ken and his wife run a small café and coffee shop called Extreme Caffeine. They have been in business for 30 years but are winding down operations in order to retire. The Wilsons are empty nesters. The couple will file as MFJ for 2016 and fall in the high income tax range.

The following table summarizes the filing attributes of each of these taxpayers. All three taxpayers will file a Schedule C, *Profit or Loss From Business.*

	Woo Kim	Will Andrews	Ken Wilson
Occupation/business	Self-employed spa owner	Independent insurance agent	Sole proprietor of a cafe
Number of years in business	1	10	30
Filing status	QW	MFJ	MFJ
Dependents	3 (under 17)	3 (2 under 17; 1 in college)	0
Tax bracket	Low	Mid	High

The final tangible property regulations offer several elective and safe harbor options. The three taxpayer scenarios used as examples in this chapter illustrate how these elections and safe harbors can be used to the taxpayer's advantage.

Note. This chapter is not intended to be an exhaustive discussion of TD 9636, because this topic was covered in both the 2014 and 2015 workbooks. For more detailed information about the final tangible property regulations, see the 2014 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Capitalization or Repair; and the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Capitalization vs. Repair Update. The 2014 workbook can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

UNIT OF PROPERTY

"Unit of property" (UOP) is a key concept in the final tangible property regulations that clarify whether an item may be deducted or must be capitalized. The UOP must be determined before an analysis of facts and circumstances can be made relating to the tax treatment of an acquisition.

The final regulations distinguish between building property and tangible nonbuilding property (i.e., personal property and nonbuilding real property) in determining the UOP.

TANGIBLE NONBUILDING PROPERTY

The UOP for tangible property other than buildings consists of components that are **functionally interdependent**. If the placing in service of one component relies on the placing in service of another component, then the components are functionally interdependent and treated as a single UOP.[47] For example, a vehicle engine is not in and of itself a UOP because it cannot function without a vehicle, and vice versa. But a computer and printer each can function independently, so they are considered separate UOPs.

The UOP analysis becomes more complicated when determining whether machinery or equipment used in manufacturing, distributing, or similar processes comprise functionally interdependent components. A "plant property" UOP is subdivided into components or groups of components that perform a discrete and major function or operation within the functionally interdependent machinery or equipment.[48]

The final regulations provide distinct rules for determining the UOP for network assets, such as railroad tracks, oil and gas pipelines, power lines, and nonbuilding leased assets.[49]

A special rule also applies only to **nonbuilding** property **for the year placed in service**. If a taxpayer properly treats a component of a UOP as a separate asset with a MACRS class different than the UOP, or the component is depreciated using a different depreciation method than the UOP, then the **component becomes a separate UOP.**[50]

In cases where either the taxpayer or the IRS makes a change in property classification to a different MACRS class or a different depreciation method for **any year other than the year the property was first placed in service**, then the UOP must be redetermined to be consistent with the change in treatment for depreciation. This rule **applies to both nonbuilding and building property**.[51]

BUILDING PROPERTY

Each building and its structural components are a single UOP. The final regulations require taxpayers to capitalize amounts paid for improvements to a UOP unless the improvements qualify for an exception. Exceptions include the safe harbor for small taxpayers, the de minimis safe harbor, and property the taxpayer elects to capitalize.

Leased property, inventory property, and capitalized improvements are subject to different standards.[52] Distinct UOP determinations also apply to condominiums and cooperatives.[53]

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47. Treas. Reg. §1.263(a)-3(e)(3).
48. Treas. Reg. §1.263(a)-3(e)(3)(ii).
49. Treas. Reg. §§1.263(a)-3(e)(3)(iii)-(iv).
50. Treas. Reg. §1.263(a)-3(e)(5)(i).
51. Treas. Reg. §1.263(a)-3(e)(5)(ii).
52. Treas. Reg. §1.263(a)-3(d).
53. Treas. Reg. §1.263(a)-3(e)(2)(iii).

The improvement tests of "betterment, adaptation, or restoration" (or BAR, discussed later in this chapter) apply separately to the different elements of a building. These improvement tests apply to the following components of building structure and systems.[54]

1. **Building structure** — the building and its structural components, other than structural components designated as building systems (e.g., walls, windows, doors, permanent flooring, etc.)

2. **Building systems** — the following structural components and the components thereof, separate from the building structure, to which the improvement rules must apply

   a. Heating, ventilation, and air conditioning systems (HVAC)

   b. Plumbing systems

   c. Electrical systems

   d. Escalators

   e. Elevators

   f. Fire protection and alarm systems

   g. Security systems

   h. Gas distribution systems

   i. Other structural components identified in published guidance in the Federal Register or the Internal Revenue Bulletin

Example 10. Will Andrews owns the building in which his insurance office is located. He began depreciating the building in 2009 as nonresidential real property. In 2016, Will converted the top floor of the building into an apartment unit, thus changing the property class for this portion of the building from nonresidential to residential. Will's building is now two distinct units of property because of a change in the MACRS class life of the residential rental portion of the UOP. Each UOP includes its own distinct building structure and building systems.

Leased Building Property

For taxpayers who lease buildings or portions of buildings, the UOP is composed of:

- Each building and its structural components and systems, or
- The portion of each building subject to the taxpayer's lease and the portion of the structural components and systems that are part of the leased building.[55]

Example 11. Woo Kim leases space for her day spa on the second floor of an office building. The UOP for Woo's spa is the portion of the building she leases, including the structural components of her leased space.

For lessee taxpayers who erect buildings on leased property, the UOP is determined by the provision for buildings and not the provisions for leased buildings.[56]

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54. Treas. Reg. §1.263(a)-3(e)(2)(ii).
55. Treas. Reg. §1.263(a)-3(e)(2)(v).
56. Treas. Reg. §1.263(a)-3(f)(2)(ii).

APPLICABLE FINANCIAL STATEMENT

The IRS grants greater leniency with regard to deductions to taxpayers who have applicable financial statements (AFS) because these statements indicate these taxpayers are using reasonable and consistent methodology that clearly reflects income. AFS fall into the following three categories.[57]

1. A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders)
2. A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for one of the following
   a. Credit purposes
   b. Reporting to shareholders, partners, or similar persons
   c. Any other substantial **nontax** purpose
3. A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency other than the SEC or the IRS

> **Note.** Whether a taxpayer has an AFS is important because it determines the taxpayer's economic useful life of an asset and it affects the taxpayer's de minimis threshold.

MATERIALS AND SUPPLIES

Qualifying material and supply expenses are not subject to capitalization. The final tangible property regulations alter IRC §§162(a) and 212, but they do not alter the treatment of material and supply expenses elsewhere in the Code.[58] For example, certain materials and supplies are still required to be included in inventory.[59]

Qualifying materials and supplies include tangible, noninventory property used or consumed in a taxpayer's business that fall within **any of** the following categories.[60]

- Units of property with an **economic useful life of 12 months or less**
- Units of property **costing $200 or less**[61]
- Items that can reasonably be expected to be **consumed in 12 months or less**, beginning with the taxpayer's first use (e.g., fuel, lubricants, and water)
- Components **used to improve, repair, or maintain a UOP** owned, leased, or serviced by the taxpayer if the component was not part of the taxpayer's original acquisition of a UOP

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57. Treas. Reg. §§1.162-3(c)(4)(iii)(A)-(C).
58. Treas. Reg. §1.162-3(b).
59. Treas. Reg. §1.471-1.
60. Treas. Reg. §1.162-3(c)
61. The final regulations grant the IRS and the Treasury Department the authority to change the amount of this threshold through published guidance. TD 9636, 2013-43 IRB 331.

ECONOMIC USEFUL LIFE

The regulations define economic useful life as "... the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or for the production of income, as applicable."[62]

The taxpayer should reference past experience with similar items to determine the expected useful life of an asset, taking into account any unique facts and circumstances related to the property but disregarding salvage value. Factors to consider include the item's wear and tear or natural decay or decline, industry-specific developments or technological changes, the taxpayer's business climate, and the taxpayer's repair or replacement policy.[63]

If the taxpayer does not have sufficient experience with an asset to determine its economic useful life, the industry's general experience can be used until the taxpayer's own experience allows more informed judgment. Modifications can be made to adjust an asset's estimated remaining useful life if the asset's condition causes a significant change in such life, but there must be a "clear and convincing" basis for any redetermination.[64]

Economic useful life is determined differently if the taxpayer has an AFS. Taxpayers with an AFS retain the useful life initially used to depreciate the item on the AFS. If the taxpayer expensed an item on the AFS that would otherwise be subject to depreciation, the taxpayer determines that asset's useful life as described in the preceding paragraphs.[65]

Example 12. Ken Wilson uses the camera feature on his smart phone to take photos of his lunch specials, which he posts daily on social media. Due to the ever-increasing number of social media apps, he often runs out of storage space on his phone. He generally replaces his phone with the latest model every 18 months at a cost of approximately $225 after trade-in. Ken does not have an AFS.

Ken's phone would not fall into the material or supply category because its economic useful life is greater than 12 months in Ken's hands; it cost more than $200; it is not a consumable item; and it is not used to improve, repair, or maintain any of Ken's property. Ken must capitalize the expense for his replacement phone and recover its cost over time.

Example 13. Will Andrews also uses a smart phone in his insurance business to take pictures of claims and to communicate with his clients. Because he has a personal history of dropping his phone and cracking its screen, he has a policy of replacing his phone annually at a cost of approximately $295 each year. Will's phone would be deemed a material or supply because the phone's economic useful life in Will's hands is 12 months or less. He can deduct the expense for a new phone.

Example 14. Woo Kim purchased a case of massage oil to receive a volume discount. There are 12 bottles in a case. Because she just purchased the business, she was not sure how long this would last her, but the spa's former owner said she went through a little over a bottle per month. Overwhelmed with her family responsibilities and the demands of her new business, Woo does not track her exact usage of the oil. She began to use the product immediately after purchase and is going through it fairly quickly. Woo may treat the oil as a material and supply expense because she can reasonably expect the case of oil to be consumed in 12 months or less.

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62. Treas. Reg. §1.162-3(c)(4)(i).
63. Treas. Reg. §1.167(a)-1(b).
64. Ibid.
65. Treas. Reg. §1.162-3(c)(4)(ii).

MATERIALS AND SUPPLIES CATEGORIES[66]

The final regulations separate materials and supplies into three categories.

1. Incidental
2. Nonincidental
3. Rotable, temporary, or standby emergency spare parts

These categories determine **when taxpayers can deduct the cost of materials and supplies** on their returns.

Incidental Materials and Supplies

Incidental materials and supplies are items carried on hand that are not inventoried, nor are records kept regarding their consumption. Examples of incidental supplies include pens, calculators, coffee pots, and toilet paper. Amounts paid to purchase or produce incidental materials and supplies are deducted in the tax year in which they are paid (or the year incurred for accrual-basis taxpayers), as long as taxable income is clearly reflected.

Example 15. Use the same facts as **Example 14.** The massage oil is considered incidental in Woo's hands because she does not keep records of its consumption. Woo is a cash-basis taxpayer, so she deducts the cost of the case of oil in the year she purchases it.

Nonincidental Materials and Supplies

Nonincidental materials and supplies are materials and supplies that do not fall into the incidental category. Examples of nonincidental materials and supplies include disposable cups at a coffee shop where the owner counts cups monthly to eliminate shrinkage, and shaving cream at a barber shop where the barber keeps track of the amount of product used weekly. The taxpayer generally deducts the cost of nonincidental materials and supplies when these items are placed in service for business use or when consumed in the taxpayer's operations.

Example 16. Use the same facts as **Example 13.** Will's phone is deemed nonincidental because he presumably keeps track of the number of phones he has. Will is permitted to deduct the cost of his replacement phone in the year he places it in service.

Rotable, Temporary, or Standby Emergency Spare Parts

Rotable and temporary parts are components used to improve, repair, or maintain a UOP owned, leased, or serviced by the taxpayer. The parts cannot be acquired as part of the taxpayer's purchase of a UOP (e.g., an engine salvaged from another vehicle a taxpayer owns is not considered a spare part because the other vehicle was the UOP).

To qualify as a **rotable** spare part, the item must be:

- Acquired for installation on a unit of property,
- Removable from that unit of property,
- Repairable or improvable, and
- Either reinstalled on a unit of property or stored for later installation.

Temporary spare parts are parts used only until a new or repaired part can be installed. Such parts are then removed and stored for later use.

66. Treas. Reg. §1.162-3.

A taxpayer generally acquires **standby emergency** spare parts to prepare for crisis situations when a key piece of equipment malfunctions. Standby emergency spare parts are considered materials and supplies if they meet all of the following criteria.

- Acquired when a particular piece of machinery or equipment is acquired
- Set aside to minimize operational down time due to equipment failure or emergency
- Readily available for use (located at or near equipment site)
- Directly related to the machinery or equipment it is intended to repair
- Normally expensive
- Must be special ordered (is not readily available)
- Not subject to periodic replacement
- Not interchangeable in another piece of machinery or equipment
- Not acquired in quantity
- Not repaired and reused

Unless an exception applies, the regulations deem that the taxpayer first uses a rotable, temporary, or standby emergency spare part in the tax year in which the taxpayer **disposes** of the part. This may delay deduction of the expense for these parts for quite some time. Applicable exceptions include an election to capitalize the expense for the qualified parts, using an optional method of accounting for **all** rotable and temporary spare parts, and an election to use a de minimis safe harbor.

Optional Method. When using the **optional method of accounting for rotable and temporary spare parts,** the taxpayer must deduct the cost of these parts when first installed. However, when the part is later removed, the taxpayer must add the fair market value (FMV) of the part to gross income. The FMV and the removal costs are then included in the part's basis. Any subsequent repairs, maintenance, or improvement costs for the part are also added to basis. These amounts cannot be deducted until the part is disposed of or reinstalled.[67]

Election to Capitalize Cost of Qualified Parts. Taxpayers may elect to capitalize and depreciate material and supply costs for rotable, temporary, or standby emergency spare parts used to repair, maintain, or improve a unit of property owned, leased, or serviced by the taxpayer. This election changes the tax treatment of these parts to capital assets; therefore, they are no longer considered materials or supplies. By electing to capitalize these costs, the taxpayer may be able to start recovering the expenses of acquiring spare parts sooner than by waiting for disposition of the parts.[68]

Ineligible Costs. Taxpayers **cannot elect** to capitalize the costs of rotable, temporary, or standby emergency spare parts under the following circumstances.[69]

- The part is intended to be used as a component of a UOP that:
  - Has an economic useful life of 12 months or less beginning with the taxpayer's use or consumption,
  - The part costs $200 or less, or
  - The part is identified in published guidance in the Federal Register or the Internal Revenue Bulletin.
- The taxpayer cannot or has not elected to capitalize the property the part is intended to fix.
- The taxpayer uses the optional method of accounting for rotable and temporary spare parts.

67. Treas. Reg. §1.162-3(e)(2).
68. Treas. Reg. §1.162-3(d).
69. Treas. Reg. §1.162-3(d)(2).

Manner of Election.[70] The election to capitalize rotable, temporary, or standby emergency spare parts must be made on a timely filed original federal tax return (including extensions) for the tax year the asset is placed in service for purposes of determining depreciation. To make the election, the taxpayer capitalizes the cost of the part in the year of acquisition but does not begin to recover the costs through depreciation until the part is placed in service. No separate election statement is necessary. For S corporations and partnerships, the election is made at the entity level and not by the partners or shareholders. The election can be made for each part. Revocation of the election requires the IRS's consent.

Example 17. Ken Wilson's café is known for the artisan bread he uses for his sandwiches. Ken bakes the bread in a deck oven he imported from France. The oven uses steam injection to obtain crisp crusts. Because the crisp crust is a signature feature of his bread and because it takes so long to obtain parts from France, Ken purchased a spare part in 2016 for $2,650 to make sure his oven is never without the steamer feature.

Ken's spare part qualifies as a standby emergency spare part. Because it is deemed a material or supply cost, it is not capitalized. However, Ken must wait to deduct the cost of the spare part until he disposes of it.

Because the part was relatively expensive and he does not know when he will need to use it — and then how long it will take until it is ultimately disposed of — Ken elects to capitalize the expense. He lists the asset on his 2016 depreciation schedule but delays recovery of his costs through depreciation until the year he places the part in service.

REPAIRS AND MAINTENANCE VS. IMPROVEMENTS

Qualifying repairs and maintenance costs are not subject to capitalization, unless the taxpayer makes an election to capitalize these costs. Improvements generally must be capitalized, unless the taxpayer elects a safe harbor.

To determine whether an expense is a deductible repair or a capitalized improvement, specific facts and circumstances must be analyzed. However, before this analysis can take place, the UOP must be established. Once the UOP is determined, the following tests should be applied to determine if an expense was incurred to better, adapt, or restore the UOP.

The BAR Tests

If an expense falls into one of the three "BAR" categories—betterment, adaptation, or restoration—it is considered an improvement to a UOP. Therefore, the costs must be capitalized, unless the taxpayer claims a safe harbor election (discussed later). The BAR tests are as follows.

1. **Betterment.**[71] An amount is paid for a betterment to a UOP if it:
   a. Ameliorates a material condition or defect that was present before the taxpayer acquired the UOP or that occurred during production;
   b. Is for a material addition — including a physical enlargement, expansion, extension, or addition of a major component to a UOP — or material increase in a UOP's capacity; or
   c. Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of a UOP.
2. **Adaptation.**[72] An adaptation prepares a UOP for a new or different use that is inconsistent with its ordinary use at the time the taxpayer placed it in service.

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70. Treas. Reg. §1.162-3(d)(3).

71. Treas. Reg. §1.263(a)-3(j).

72. Treas. Reg. §1.263(a)-3(l).

3. **Restoration.**[73] A restoration replaces, returns, or rebuilds a UOP, or reinstates a UOP's basis after an adjustment has been made to it. A restoration includes amounts paid for any of the following purposes.

   a. Replace a major component of a UOP for which the taxpayer has properly deducted a loss for that component, other than a casualty loss

   b. Replace a component of a UOP for which the taxpayer 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

   c. Restore a UOP for which the taxpayer is required to take a basis adjustment as a result of a casualty loss

   d. Return a UOP to its ordinarily efficient operating condition if the UOP has deteriorated to a state of disrepair and is no longer functional for its intended use

   e. Rebuild a UOP to a like-new condition after the end of its class life

   f. Replace the part or combination of parts that comprise a major component or a substantial structural part of a UOP

Example 18. Ken Wilson purchased a used double-stack convection oven on Craigslist for $2,000. The oven was listed in "as is" condition, with a disclosure stating that one of the ovens was not heating up properly. Knowing that he could fix it himself, Ken purchased $600 in parts to restore the oven to full working order.

Ken applies the BAR test to the UOP. He determined that the parts were purchased to correct a defect that was present when he purchased the oven. This classifies the expenditure as a betterment, which is an improvement. Therefore, Ken must capitalize the expense for the oven and the parts.

Example 19. When Woo Kim purchased the day spa, the leased space was configured with two treatment rooms, a nail salon, a pedicure room, and an office. Woo wanted to increase space for massages, so she combined the nail salon and pedicure room into one space at a total cost of $10,000. She placed the remodeled area in service on July 1, 2016. This conversion required her to move walls and electrical lines in order to make the nail and pedicure room large enough to contain all the furniture and equipment needed. She did not purchase any new equipment or furnishings.

First, Woo applied the rules for leased property to these remodeling activities and determined that the UOP is composed of the portion of the building subject to her lease and the structural components and systems associated with this leased portion. Therefore, the UOP is the whole leased space.

Then, Woo applied the BAR test to determine if the costs must be capitalized as an improvement. Even though Woo increased the size of one room, she did not increase the overall footprint of the leased space, which is the UOP. She also did not materially increase the productivity, efficiency, strength, quality, or output of the UOP, nor did she correct a defect that was present when she took over the spa. Therefore, Woo determines the renovations are not a betterment.

The remodeling expenses do not adapt the leased space to a new or different use, so they cannot be considered an adaptation. The changes do not constitute a restoration, because she is not restoring basis and the remodeling does not replace or rebuild the space to like-new condition, nor return it to its original condition.

Because the remodeling expenses do not fall into any of the BAR categories, the costs are not considered an improvement subject to capitalization. Therefore, Woo may deduct her remodeling costs as ordinary business expenses.

73. Treas. Reg. §1.263(a)-3(k).

Example 20. In the course of converting a portion of his office building to residential, Will Andrews decided to fix up a detached garage at the back of his lot. The garage had not been used in some time and the whole structure was leaning to one side. Will hired a contractor to brace the walls, repair the roof, and put in new garage doors. The total cost of the project was $6,500.

First, Will determined that the UOP is the detached garage, because it is a separate building. Then, he determined that the project is classified as a restoration, because it returns the garage from a state of disrepair to its normal intended purpose. Will must capitalize the expense of restoring the garage and recover his costs through depreciation when he places the garage in service.

Election to Capitalize Repairs and Maintenance Costs

The final regulations allow taxpayers to elect to capitalize and depreciate the costs of repairs and maintenance as qualified improvements, if both of the following occur. [74]

1. The costs are incurred in carrying on a trade or business.
2. The taxpayer treats the amounts as capital expenditures on its books and records regularly used for computing income.

This election reduces administrative burdens on taxpayers by permitting their tax treatments to match their capitalization policies used for books and records. It can also be used as a tax planning tool.

A taxpayer electing to capitalize repair and maintenance costs may still apply the de minimis safe harbor, the safe harbor for small taxpayers, and/or the routine maintenance safe harbor to repair and maintenance costs that are not treated as capital expenditures on its books and records. These safe harbors are discussed later.

Taxpayers making this election must apply the election to **all** repair and maintenance amounts that it treats as capital expenditures on its books and records for that tax year. Depreciation on these costs begins when the deemed improvements are placed in service.[75]

The cost of repairing or maintaining rotable or temporary spare parts is **not** eligible for this election if the taxpayer uses the optional method of accounting for these parts.[76]

Manner of Election. To make this irrevocable election, the taxpayer must attach a statement to their timely filed original federal tax return (including extensions) for the tax year in which the improvement was placed in service. The statement must include the following information.[77]

- Title: "Section 1.263(a)-3(n) Election"
- Taxpayer's name
- Taxpayer's address
- Taxpayer's identification number
- A statement that the taxpayer is making the election to capitalize repairs and maintenance costs under §1.263(a)-3(n)

Elections for S corporations and partnerships are made at the entity level, and not by individual shareholders or partners.

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74. Treas. Reg. §1.263(a)-3(n).
75. Treas. Reg. §1.263(a)-3(n)(1).
76. Treas. Reg. §1.263(a)-3(n)(3).
77. Treas. Reg. §1.263(a)-3(n)(2).

Example 21. Woo Kim's 2016 net income from the spa totaled $18,500, without taking into account the $10,000 of remodeling costs she incurred to reconfigure the space. As shown in **Example 19,** Woo is eligible to deduct the entire $10,000 in 2016, the year she placed the remodeling in service.

As a widow, Woo is the sole support of her three children. The only 2016 income she has is from the spa. She did not make any estimated tax payments and has no withholding or carryover credits for 2016. Woo treats the $10,000 remodeling as a capital expenditure on her books and records.

Woo consulted a tax professional, who prepared the following chart to help her decide whether she is better off deducting the entire $10,000 in 2016 or electing to capitalize her remodeling costs.

	Expense	**Capitalize**
Spa income	$18,500	$18,500
Remodeling costs/allowable depreciation	(10,000)	(500)
Net earned income	$ 8,500	$18,000
Income tax	$ 0	$ 0
Self-employment tax	$ 1,201	$ 2,543
Less: earned income credit	(3,544)	(6,269)
Less: additional child tax credit	(735)	(2,059)
Net refund	$ 3,078	$ 5,785

If Woo deducts the entire $10,000 in remodeling costs, her adjusted gross income (AGI) would be $7,899 ($8,500 − $601 (half of $1,201 SE tax)). After the $12,600 QW standard deduction and $16,200 ($4,050 × 4) exemption amounts are applied, she will not owe any 2016 income tax. Woo would reduce her self-employment (SE) tax from $2,543 to $1,201, a savings of $1,342. However, she will also reduce her earned income to only $8,500, which, in turn, will reduce her 2016 EIC and her additional child tax credit.

If Woo elects to capitalize her leasehold improvements, she will depreciate the $10,000 expense over 15 years. Her first-year depreciation rate would be 5%, or $500 ($10,000 × 5%). (She opts out of the bonus depreciation.) Woo would still owe no income tax, because her $16,728 ($18,000 − $1,272 (half of $2,543 SE tax)) AGI is less than her $28,800 ($12,600 + $16,200) standard deduction and exemption allowances.

Because of the large increase in EIC and additional child tax credit, Woo's 2016 refund would increase by $2,707 ($5,785 – $3,078) if she elects to capitalize the $10,000 remodeling costs. This would give her an immediate tax benefit, plus retain a portion of the remodeling deduction for another 14 years.

Because Woo hopes her spa income will increase in future years and she needs the extra money now, she elects to capitalize her remodeling costs. To make this election, Woo attaches the following statement to her timely filed 2016 return.

Section 1.263(a)-3(n) Election

Woo Kim

356 West Main Street

Champaign, IL 61820

SSN: 123-45-6789

The above named taxpayer is making an election to capitalize repair and maintenance costs under §1.263(a)-3(n).

SAFE HARBORS

Instead of analyzing expenditures to determine if costs must be capitalized or may be expensed, the regulations allow the following alternatives.

1. Routine maintenance safe harbor
2. Safe harbor for small taxpayers
3. De minimis safe harbor

Routine Maintenance Safe Harbor[78]

Despite the copious number of examples provided in the regulations, it is often still difficult to discern a repair from an improvement. The final regulations help guide taxpayers through these gray areas with the introduction of the routine maintenance safe harbor.

The routine maintenance safe harbor allows taxpayers to deduct work performed that meets **all** the following parameters.

- The taxpayer uses the property in a trade or business.
- As a result of the business use of the property, the taxpayer expects to perform maintenance on a **recurring** basis.
- The recurring maintenance will keep the property in its **ordinarily efficient operating condition.**
- At the time the property is placed in service, the taxpayer **reasonably expects** to perform the recurring maintenance:
  - More than once over the next 10 years for building property and building systems, or
  - More than once during the ADS class life of nonbuilding property.

If a taxpayer does not actually perform the maintenance work more than once in the prescribed time allotments, it will not invalidate this safe harbor. The taxpayer can rely on the following factors in making a reasoned prediction.

- The recurring nature of the activity
- Industry practice
- Manufacturers' recommendations
- The taxpayer's experience with similar or identical property

Routine maintenance performed on rotable and temporary parts generally qualifies for this safe harbor, unless the taxpayer uses the optional method of accounting for these parts.

78. Treas. Reg. §1.263(a)-3(i).

Routine maintenance does not include the following amounts.

1. Betterment to a UOP
2. Replacement of a component of a UOP for which the taxpayer has properly deducted a loss for that component (other than a casualty loss)
3. Replacement of a component of a UOP for which the taxpayer 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
4. Restoration of damage to a UOP for which the taxpayer is required to take a basis adjustment as a result of a casualty loss or relating to a casualty event subject to the limits identified in Treas. Reg. §1.263(a)-3(k)(4)
5. Return of a UOP 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
6. Adaptation of a UOP to a new or different use
7. Repairs, maintenance, or improvement of network assets
8. Repairs, maintenance, or improvement of rotable and temporary spare parts to which the taxpayer applies the optional method of amounting for rotable and temporary spare parts

Example 22. Ken Wilson purchased a used espresso machine for his café. New espresso machines cost more than $10,000, which is not in the budget because Ken is planning on retiring soon. Espresso bar sales now account for nearly 20% of the café's total income, so it is important that this used machine stay in good working order.

Based on the manufacturer's recommendations, Ken hired a service to perform annual preventative maintenance on the espresso machine starting in 2016. Shortly after the first time the company serviced his machine, they went out of business. He has not found a replacement service yet and worries he will not be able to find one in his area. Ken can still use the routine maintenance safe harbor for his service costs in 2016 because he reasonably expects to perform annual maintenance on the machine to keep it in its ordinarily efficient operating condition.

Safe Harbor for Small Taxpayers[79]

The final regulations provide another safe harbor that allows qualified small taxpayers to deduct certain costs for **eligible building property.** Under the small taxpayer safe harbor, taxpayers may deduct eligible expenditures in the year paid.

Qualified small taxpayers must have **average annual gross receipts of $10 million or less for the three preceding tax years.** If a taxpayer has not been in business for three years, the average annual gross receipts of the years, including short years, that the taxpayer or their predecessor has been in business are used to average gross receipts. Short years are annualized by multiplying the gross receipts for the short year by 12 and dividing that product by the number of months in the short year.

The term "eligible building property" applies to each unit of building property that has an **unadjusted basis of $1 million or less.** A taxpayer who leases building property determines the unadjusted basis of the leased property by multiplying the undiscounted amount of rent paid or expected to be paid by the taxpayer for the entire term of the lease. This term should include renewal periods if the taxpayer has a reasonable expectation of renewal.

79. Treas. Reg. §1.263(a)-3(h).

Qualified Expenditures. Qualified expenditures under this safe harbor include repairs, maintenance, improvements, and similar activities performed on each eligible building, limited to the lesser of:

- 2% of the building's unadjusted basis, or
- $10,000.[80]

Qualified expenditures otherwise may not be capitalized under the de minimis safe harbor election or the routine maintenance safe harbor for buildings.

The limitation on expenditures applies individually to buildings (i.e., if a taxpayer owns multiple buildings, the limitations are applied separately to each building). If the expenditures for a particular building **exceed** the limitation threshold, the small taxpayer safe harbor cannot be applied to that building. The taxpayer then must determine the UOP and apply the BAR tests to the expenditures. The taxpayer may apply the safe harbor for routine maintenance and the de minimis safe harbor election to expenditures that do not qualify for the small taxpayer safe harbor.

Manner of Election. Taxpayers make the small taxpayer safe harbor election for the tax year in which amounts are paid for qualifying repairs, maintenance, improvements, and similar activities on a building-by-building basis. The irrevocable election is made by attaching a statement to the taxpayer's original federal tax return that is timely filed, including extensions.

The election statement must include all of the following information.

- Title: "Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers"
- Taxpayer's name
- Taxpayer's address
- Taxpayer's identification number
- A description of each eligible building property to which the taxpayer is applying the election

Elections for S corporations and partnerships are made at the entity level and not by the individual shareholders or partners.

Note. When the IRS requested public input on the final repair regulations, one commenter stated that small taxpayers generally do not have the means or resources to apply the improvement rules to their building structures and systems, as required under the then temporary regulations. The commenter suggested permitting taxpayers to deduct up to a $10,000 annual threshold for expenditures on buildings with an initial cost of $1 million or less. The final regulations included a similar provision for qualifying small taxpayers based on the input of **one** commenter.

De Minimis Safe Harbor Election[81]

In addition to the exceptions and safe harbors that allow acquisition costs of qualifying materials and supplies and repair and maintenance costs as eligible deductions, taxpayers may also elect to deduct a UOP with a purchase price falling within a de minimis safe harbor zone. This de minimis threshold ranges from **$2,500 for taxpayers without an AFS to $5,000 for taxpayers with an AFS.**[82] Without this safe harbor election, the cost cap is $200 under the materials and supplies rules.

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80. The final regulations grant the IRS the authority to adjust these amounts through published guidance.

81. Treas. Reg. §1.263(a)-1(f).

82. IRS Notice 2015-82, 2015-50 IRB 859.

The IRS created this safe harbor zone as an "administrative convenience," allowing taxpayers to apply a bright line when determining whether an expenditure that otherwise must be capitalized can qualify for deduction.

This safe harbor is not intended to place a limitation on deductions. Expenses that otherwise qualify as deductible costs are not held to the $2,500 or $5,000 thresholds. Taxpayers may continue to deduct these qualifying expenses without regard to the amount of the expense.

Increased Threshold for Non-AFS Taxpayers. The IRS raised the de minimis threshold amount for taxpayers without an AFS from $500 to $2,500 per invoice or item for tax years **beginning on or after January 1, 2016.**[83] However, **the increased threshold can generally be considered retroactive**, because the IRS agreed to extend audit protection for previous tax years to non-AFS taxpayers who expensed items up to the $2,500 threshold, as long as the expense otherwise qualifies for deduction. The IRS also extends the increased threshold amount to issues under consideration in examination, appeals, or before the U.S. Tax Court for tax years beginning after December 31, 2011, and ending before January 1, 2016.[84]

> **Observation.** The jump from a $500 safe harbor threshold to a $2,500 threshold for taxpayers without an AFS was a direct result of feedback submitted to the IRS on behalf of interested parties. In response to a formal request for comment, the IRS received over 150 letters in support of raising the $500 safe harbor threshold for taxpayers without an AFS. Comments suggested increases ranging from $750 to $100,000.
>
> In general, commenters stated that the $500 limitation still imposed a burden on small taxpayers, citing that the cost of commonly purchased items such as tablet computers and cell phones often exceed $500. Commenters also noted the wide gap in safe harbor limitations for taxpayers with an AFS and those without, expressing concern that small businesses could not afford to obtain an AFS in order to benefit from the larger limitation.

Eligibility Requirements for De Minimis Safe Harbor. Taxpayers electing the de minimis safe harbor must apply the threshold amount to **all tangible property placed in service during the tax year, as well as to material and supply costs for which an exception does not apply.**

To be eligible to apply the de minimis safe harbor, taxpayers **with an AFS** must meet **all** of the following requirements.

- Have a **written** accounting procedure in place **at the start of the tax year** that states that expenditures must be treated as expenses for nontax financial accounting purposes if they meet one of the following conditions
  - Have an economic useful life of 12 months or less
  - Fall below a specified dollar amount
- Adhere to the written procedure by treating applicable amounts as expenses on the taxpayer's books and records
- Apply the expense treatment only to amounts that **do not exceed $5,000 per item**, including applicable transaction costs (and allocated costs for multiple item invoices)

> **Note.** Taxpayers with accounting procedures in place for nontax purposes that allow for the expensing of items with dollar amounts below the applicable safe harbor thresholds ($2,500 non-AFS; $5,000 with AFS), may wish to consider revising their policies to reflect a dollar amount in line with the de minimis safe harbor threshold to maximize their deductions.
>
> However, because procedures must be in place at the beginning of the year to qualify for the safe harbor, any mid-year changes to policies and procedures would have to become effective at the beginning of the following year.

83. Ibid.

84. Ibid.

Taxpayers **without an AFS** must meet **all** of the following requirements to be eligible to apply the de minimis safe harbor.

- Have a nontax accounting procedure in place **at the start of the tax year** that treats property with an economic useful life of 12 months or less, or expenditures of a specified dollar amount as expenses on the taxpayer's books and records (This plan does **not** have to be written.)
- Treat the amount paid for property as an expense on their books and records in accordance with the accounting procedure
- Limit the expense treatment only to amounts that **do not exceed $2,500 per item,**[85] including applicable transaction costs (and allocated costs for multiple item invoices)

Although a written policy is not required, an example of a financial accounting policy follows.

[Company Name] Financial Accounting Policy: Capitalization

The purpose of this policy is to create an accurate assessment of the company's financial position. The following capitalization policy will be followed in accounting for asset acquisitions.

Assets that meet both of the following requirements will be deemed "capital assets" and must be capitalized and depreciated for bookkeeping purposes.

1. A unit of property that has an economic useful life to the company in excess of 12 months
2. A unit of property that was acquired or produced for $___ or more

All assets acquired for a cost less than $____ must be expensed for bookkeeping purposes.

All assets with an economic useful life to the company of 12 months or less must be expensed for bookkeeping purposes, regardless of cost.

This policy is intended to satisfy the provisions of the de minimis safe harbor election of Treasury Regulation §1-263(a)-1(f).

It is obviously tempting to set the dollar threshold at the $2,500 maximum amount. However, because the taxpayer's nontax books and records must reflect the same treatment that the taxpayer elects on their tax return, it is prudent to examine the taxpayer's unique facts and circumstances before setting the threshold limit.

Example 23. Ken Wilson plans to sell his café and retire soon. As such, he opens his books to prospective buyers. In an effort to show as much income as possible, Ken adopts a $500 threshold for capitalization for 2016. This way, he is protected from challenge when deducting low-cost improvements but his books reflect more income and make his business appear more attractive to prospective buyers.

Ineligible Expenses. The following expenses do not qualify for the de minimis safe harbor election.

- Inventory property costs
- Land costs
- Expenses for rotable, temporary, and standby emergency spare parts that the taxpayer elects to capitalize and depreciate
- Expenses for rotable and temporary spare parts that the taxpayer accounts for under the optional method of accounting

Expenses associated with the direct or allocated indirect costs of other property the taxpayer produced or acquired for resale may have to be capitalized under IRC §263A.

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85. Ibid.

Transactional Costs. Transactional costs include the additional costs of acquiring or producing tangible property, such as delivery charges, installation fees, and shipping. If the transactional costs are included in the same invoice as the tangible property, then the taxpayer must include these costs in the election to use the de minimis safe harbor. If the costs are not included on the same invoice, the taxpayer is not required to include transactional costs.

Example 24. Ken Wilson purchased a used drink cooler on eBay for $2,400. Because the seller requested local pickup, Ken arranged for a delivery service to pick up the cooler and deliver it to his business. He paid the eBay seller $2,400, and the delivery service separately billed him $250. Ken does not have an AFS, so his de minimis safe harbor threshold is $2,500 — if he chooses to adopt the maximum threshold for nontax purposes.

Ken could elect to deduct the cost of the cooler on his return, because the $2,400 cooler invoice was under the de minimis threshold for taxpayers without an AFS. The delivery charge does not have to be included because it was separately billed. However, for tax planning purposes, Ken may choose to ignore the safe harbor and depreciate the cooler as long as he does not use the de minimis safe harbor election for any other property in 2016.

Example 25. Woo Kim purchased a massage table on eBay for $2,400. The seller charged an additional $250 for shipping and handling charges. Woo paid the eBay seller $2,650. Woo does not have an AFS, so her de minimis safe harbor threshold is limited to $2,500.

Woo cannot deduct the cost of the massage table on her return, because the $250 shipping and handling charges were included on the invoice with the massage table. This brought the total cost of the transaction to $2,650, which exceeds the de minimis threshold for taxpayers without an AFS. Woo must capitalize this expense and recover her costs through depreciation when she places the table in service.

If multiple items are charged on the same invoice and transactional fees apply, the taxpayer must **allocate** a portion of the transactional charges to each item of tangible property. Any reasonable method may be used for the allocation, including specific identification, pro rata, or weighted average based on the property's relative cost.

Example 26. Will Andrews purchased new furniture on July 1, 2016, for the reception area of his insurance office, consisting of a couch, two chairs, two end tables, and a coffee table. He placed the furniture in service immediately upon delivery one week later. The total invoice, including sales tax, shipping, and handling was $4,878. Will does not have an AFS. The invoice lists the following costs.

Couch	$2,400
Chair #1	600
Chair #2	600
Coffee table	300
End table #1	150
End table #2	150
Subtotal	$4,200
Sales tax (9%)	378
Shipping and handling	300
Total invoice	$4,878

Will had a good year, so he would like to take advantage of the de minimis safe harbor election to expense the cost of these furnishings on his 2016 return. He first must allocate the transactional costs to each unit of tangible property. He applies the 9% sales tax rate separately to each item. Will then allocates the shipping and handling charges using pro-rata allocations based on the relative cost of each item to the total cost of the items. For example, $171 of shipping and handling was allocated to the couch (($2,400 ÷ $4,200) × $300). These calculations are shown in the following table.

Item	Item Cost	Allocated Tax (9%)	Allocated S&H	Total Item Cost
Couch	$2,400	$216	$171	$2,787
Chair #1	600	54	43	697
Chair #2	600	54	43	697
Coffee table	300	27	21	348
End table #1	150	14	11	175
End table #2	150	13	11	174
Total invoice	$4,200	$378	$300	$4,878

Because Will does not have an AFS, he is limited to a $2,500 threshold for each unit of tangible property placed in service. Will determines that each item of furniture is a separate UOP because each item functions independently of the other.

Thanks to the astute efforts of his tax practitioner and some predictive tax planning, Will increased his capitalization threshold to $2,500 for 2016. Will had the following capitalization policy in place at the beginning of 2016 and his bookkeeper followed it to the letter.

Andrews Insurance Company's Financial Accounting Policy: Capitalization

The purpose of this policy is to create an accurate assessment of the company's financial position. The following capitalization policy will be followed in accounting for asset acquisitions.

Assets that meet both of the following requirements will be deemed "capital assets" and must be capitalized and depreciated for bookkeeping purposes.

1. A unit of property that has an economic useful life to the company in excess of 12 months
2. A unit of property that was acquired or produced for more than $2,500

All assets acquired for a cost that does not exceed $2,500 must be expensed for bookkeeping purposes.

All assets with an economic useful life to the company of 12 months or less must be expensed for bookkeeping purposes, regardless of cost.

This policy is intended to satisfy the provisions of the de minimis safe harbor election of Treasury Regulation §1-263(a)-1(f).

Will is allowed to expense each unit of furniture except for the couch, because the allocated invoice costs for sales tax, shipping, and handling push the price of the couch over the threshold limit. Will must capitalize the $2,787 cost of the couch and recover his costs through depreciation.

Alternatively, Will could use IRC §179 to write off the full amount of the couch in 2016, the year he placed it in service.

Taxpayers may not abuse the de minimis safe harbor election by manipulating transactions so that they fall under the applicable threshold limit. For instance, if Will purchased a sectional couch, he could not arrange to have the seller bill each section of the couch separately in order to qualify for the de minimis safe harbor election.

Manner of Election. To make the de minimis safe harbor election, the taxpayer must attach a statement to their timely filed original federal tax return, including extensions, for the tax year in which the amounts are paid. The election statement must include all of the following information.

- Title: "Section 1.263(a)-1(f) de minimis safe harbor election"
- Taxpayer's name
- Taxpayer's address
- Taxpayer's identification number
- A statement that the taxpayer is making the de minimis safe harbor election under §1.263(a)-1(f)

Elections for S corporations and partnerships are made at the entity level, and not by the individual shareholders or partners. The common parent of a consolidated group that files a consolidated income tax return makes the election for each member of the consolidated group. The statement must include the names and identification numbers for each member for which the election is made.

Once made, the de minimis safe harbor election is **irrevocable** for that year.

FINAL REPAIR REGS VS. IRC §179 AND BONUS DEPRECIATION

On December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), was signed into law. The PATH Act permanently set the §179 maximum deduction amount at **$500,000**. The $500,000 limit is reduced by the amount by which the cost of qualifying property placed in service during the tax year exceeds $2 million. **The $500,000 and $2 million amounts are indexed for inflation for tax years beginning after 2015.** For tax years beginning in 2016, the inflation-adjusted amounts are $500,000 and $2,010,000, respectively.[86]

The PATH Act also extended bonus depreciation through 2019. The bonus depreciation rate is 50% for calendar years 2015 through 2017, 40% for 2018, and 30% for 2019.

> **Note.** More information about the PATH Act is provided in the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 6: New Developments.

IRC §179 and De Minimis Safe Harbor Overlap

The final tangible property regulations and §179 overlap regarding some expense areas. Both apply to materials and supplies and property eligible for the de minimis safe harbor election. As mentioned earlier, materials and supplies that cost less than $200 may be expensed without regard to the §179 deduction limitation. Likewise, amounts expensed under the de minimis safe harbor election do not affect the §179 deduction limitation.

Taxpayers who elect the de minimis safe harbor must apply the election to all items that otherwise must be capitalized and that cost less than the taxpayer's allowable de minimis threshold. However, §179 property is not chargeable to a capital account,[87] thereby allowing a taxpayer to claim both §179 and the de minimis safe harbor elections in the same tax year.

IRC §179 cannot be used to reduce taxable income below zero. There is no such restriction on expensing amounts under the de minimis safe harbor or any of the other provisions of the final repair regulations.

86. Rev. Proc. 2016-14, 2016-9 IRB 365.

87. IRC §179(a).

Under both IRC §179 and the de minimis safe hardbor, the taxpayer is electing not to capitalize the assets. Thus, the elections are not mutually exclusive. Some practitioners may group small assets together and write them off using the IRC §179 election. The practitioner may also make the de minimis safe harbor election to protect the taxpayer in the event that an IRS examination finds other items that should have been capitalized.

The IRC §179 election applies only to active trades and businesses. The de minimis safe harbor election applies to both active and passive activities. Thus, it may be beneficial for taxpayers with multiple types of activities to make the de minimis safe harbor election in addition to making the IRC §179 election.

Advantages of §179 Deduction

Taxpayers realize ordinary income when they dispose of items deducted under the de minimis safe harbor, and this income may be subject to SE tax as well as ordinary income tax, as discussed later in the chapter. However, items deducted under §179 are reported on Form 4797, *Sales of Business Property*. This income is not subject to SE tax, and a portion of the proceeds may be eligible for preferential capital gains tax rates.

> **Observation.** Although taxpayers can use the new de minimis safe harbor rules to expense property, they should not ignore §179 elections. This is especially true now that Congress has permanently increased the §179 limits.

Advantages of the De Minimis Safe Harbor Election

When the taxpayer cannot use IRC §179 to expense the purchase of items that also qualify for the de minimis safe harbor, it may be beneficial to use the safe harbor. Applicable situations include the following.

- The items are used in activities that do not qualify as a trade or business that is actively conducted by the taxpayer, such as most rental activities.
- The dollar limitations under IRC §179 are already exhausted by other purchases.
- The IRC §179 deduction is limited by current year net taxable income from active trades or businesses.
- The items purchased are not qualified IRC §179 property, but qualify for the de minimis safe harbor. For example, IRC §179(d)(2) prohibits using the IRC §179 election to expense property acquired from related parties. The regulations for the de minimis safe harbor do not contain this restriction.

DISPOSITIONS UNDER THE TANGIBLE PROPERTY REGULATIONS

The regulations deem the following situations to be dispositions.

- Transfer of ownership interest in an asset
- Permanent withdrawal of an asset from a taxpayer's trade or business or the production of income
- The sale or exchange of an asset
- The retirement of an asset
- The physical abandonment of an asset
- The destruction of an asset
- The retirement of a structural component (or a portion thereof) of a building (if the partial disposition rule applies)

SALE OF TANGIBLE PERSONAL PROPERTY EXPENSED UNDER THE DE MINIMIS SAFE HARBOR

If a taxpayer applies the de minimis safe harbor to property, when that property is sold or otherwise disposed of, it is **not** treated as a capital asset under IRC §1221 nor as depreciable property used in a trade or business under §1231.[88] To fully absorb the meaning of the preceding sentence, it is important to review the basics of §§1221 and 1231.

Review of IRC §§1221 and 1231

IRC §1221 describes a capital asset by stating what it is not. Among other things, a capital asset is not inventory and it is not depreciable business property used in a trade or business. The latter type of property falls under §1231.

A capital asset qualifies for preferential tax treatment when it is sold, notably in the form of reduced tax rates. In 2016, taxpayers in the 10% and 15% tax brackets pay no income tax on long-term capital gains. The capital gains tax rate is 15% for income in the 25–35% tax brackets and 20% for income in higher brackets.

> **Note.** Higher maximum capital gains tax rates apply to some sales, such as depreciable real estate, some small business stock, and collectibles. In addition, the net investment income tax may apply.

IRC §1231 property must be used in a trade or business and held for over one year. It generally includes all depreciable assets and real property, regardless of whether it is depreciable. Amortizable intangibles, such as acquired goodwill, also are §1231 assets. (Self-created intangibles, such as goodwill generated by a business, are considered capital assets under IRC §1221 and not IRC §1231.) IRC §1231 does not include property held in inventory.

IRC §1231 property receives the best of both worlds in terms of tax treatment. Losses are deducted as ordinary income, while gains in excess of the depreciation component qualify for the preferential capital gains tax rates.[89]

> **Note.** For more information about §1231 property, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 1: Form 4797. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Ordinary Income Treatment of Gains

Items deducted under the de minimis safe harbor election are not characterized as capital expenditures under IRC §1231. Rather, **taxpayers treat these expenses as normal business expenses**, provided they qualify as ordinary and necessary expenses incurred in carrying on a trade or business.

Because tangible property deducted under the de minimis safe harbor election cannot be considered capital assets or §1231 property, the income derived from dispositions of such property is **ordinary income**. This means the proceeds of these dispositions do not qualify for preferential capital gain tax treatment.

Example 27. At a bankruptcy auction, Ken Wilson bought another espresso machine for $800 on January 31, 2015. He used the machine in his business, Extreme Caffeine, until November 30, 2016, when he sells the equipment for $6,000.

In 2015, Ken's tax preparer deducted the cost of the espresso machine using the de minimis safe harbor election. On his 2016 return, the entire $6,000 sales price must be reported as ordinary income. Because Ken is in the 25% tax bracket, he pays $1,500 ($6,000 × 25%) of income tax on the sale of the machine.

88. Treas. Reg. §1.263(a)-1(f)(3)(iii).

89. IRS Pub. 544, *Sales and Other Dispositions of Assets.*

Example 28. Use the same facts as **Example 27,** except in 2015 Ken's tax preparer deducted the $800 cost of the machine using the IRC §179 election. On Ken's 2016 return, the entire $6,000 is reported as gain. However, only the $800 depreciation component is taxed as ordinary income. The remaining $5,200 gain ($6,000 – $800) is taxed as capital gain income subject to capital gain rates. Because Ken is in the 25% income tax bracket, he pays $980 ($800 × 25% + $5,200 × 15%) of income tax on the sale of the machine.

Self-Employment Tax on Gains

There are two schools of thought on how to appropriately account for the disposition of tangible personal property expensed under the de minimis safe harbor for units of property costing less than $2,500 (or $5,000 for taxpayers with an AFS). Under one interpretation of the Code and regulations, gain on the disposition is not subject to SE tax. Under the other interpretation, it is. As of the date of this book's publication, the IRS had not issued any guidance on this issue.

Argument against paying SE tax on disposition gains. The de minimis safe harbor election is found in Treas. Reg. §1.263(a)-1(f). This regulation permits taxpayers to write off the cost of assets that would otherwise be required to be capitalized under IRC §263 and recovered through depreciation or expensing. The regulation does not convert the expensed assets from capital assets under IRC §263 to materials and supplies under IRC §162.

Gains from the disposition of IRC §263 property are excluded from SE tax under Treas. Reg. §1.1402(a)-6(a). Specifically, the regulation states:

> *. . . it is immaterial whether a gain or loss is treated as a capital gain or loss or as an ordinary gain or loss for purposes other than determining net earnings from self-employment. For instance, where the character of a loss is governed by the provisions of section 1231, such loss is excluded in determining net earnings from self-employment even though such loss is treated under section 1231 as an ordinary loss.*

If a taxpayer elects to apply the de minimis safe harbor, all amounts under the applicable limit that are paid for the acquisition or production of units of tangible property are excluded from capitalization. Even purchases that would normally fall under materials and supplies are captured in the election. The regulations specifically state that no items deducted under the de minimis safe harbor are treated as material and supplies.[90] Consequently, none of the proceeds from selling the items should be treated as expense recovery.

Argument supporting paying SE tax on disposition gains. IRC §111(a) requires that the recovery of any amount deducted in a prior year is included in income to the extent that the deduction yielded a tax benefit. Consequently, recovery items are included in SE income.

Taxpayers must report recovery income such as scrap sales, recovered bad debts, fuel tax refunds, and credits for fuels on Schedule C.[91] Under this argument, gains from sales of items expensed using the de minimis safe harbor election are akin to these types of income and should be reported on the schedule where the deduction was taken.

Reporting Gains Under Each SE Tax Theory. How to report a gain from the disposition of an item that was expensed under the de minimis safe harbor election depends on which of the theories that the tax practitioner believes is correct. Gains not subject to SE tax are reported on Form 4797; gains subject to SE tax are reported as recoveries on the form or schedule used for claiming the de minimis deduction.

90. Treas. Reg. §1.263(a)-1(f)(1).

91. Instructions for Schedule C.

Gains Not Subject to SE Tax. The sale is reported in part II of Form 4797. Part I does not apply because the property is excluded from IRC §1231 treatment. Part III does not apply because there is no depreciation subject to recapture.

> **Note.** See the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: Agricultural Issues and Rural Investments, for a more detailed explanation of why part II of Form 4797 is used.

Example 29. Use the same facts as **Example 27.** Part II of Ken's 2016 Form 4797 follows. The $6,000 gain flows to line 14 of Form 1040.

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
▶ Attach to your tax return.
▶ Information about Form 4797 and its separate instructions is at *www.irs.gov/form4797.*

OMB No. 1545-0184
2016
Attachment Sequence No. **27**

Name(s) shown on return: **Ken Wilson**
Identifying number: **333-67-1040**

... the gross proceeds from sales or exchanges reported to you for 2016 on Form(s) 1099-B or 1099-S (or ...
... capital gain on the Schedule D filed with your ... See instructions **9**

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

Espresso Machine	01/31/2015	11/30/2016	6,000	0	0	6,000

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	6,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	6,000

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2016)

> **Note.** For a thorough explanation of how to report dispositions on Form 4797, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 1: Form 4797. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Gains Subject to SE Tax. As stated previously, gains subject to SE tax are reported as recoveries on the form or schedule used for claiming the de minimis deduction. The proceeds are included in "other income."

Example 30. Use the same facts as **Example 27.** Part I of Ken's 2016 Schedule C follows. The $6,000 gain is included in his gross income subject to SE tax.

SCHEDULE C (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)
▶ Information about Schedule C and its separate instructions is at *www.irs.gov/schedulec.*
▶ Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074
2016
Attachment Sequence No. **09**

Name of proprietor: **Ken Wilson**
Social security number (SSN): **333-67-1040**

A Principal business or profession, including product or service (see instructions): **Cafe**
B Enter code from instructions ▶ **722513**
C Business name. If no separate business name, leave blank. **Extreme Caffeine**
D Employer ID number (EIN), (see instr.)
E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code
F Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶
G Did you "materially participate" in the operation of this business during 2016? If "No," see instructions for limit on losses ☒ Yes ☐ No
H If you started or acquired this business during 2016, check here ▶ ☐
I Did you make any payments in 2016 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☒ No
J If "Yes," did you or will you file required Forms 1099? ☐ Yes ☐ No

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked ▶ ☐	1	450,000
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	450,000
4	Cost of goods sold (from line 42)	4	150,000
5	**Gross profit.** Subtract line 4 from line 3	5	300,000
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	6,000
7	**Gross income.** Add lines 5 and 6 ▶	7	306,000

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

BUILDING PROPERTY DISPOSITIONS

If a taxpayer claims deductions for building property improvements under the de minimis safe harbor election, the improvements generally are not sold separately from the rest of the building. Therefore, the improvements are part of the building sale.

The building and corresponding building system components and improvements are reported on the taxpayer's Form 4797. Consequently, **the disposition of building property improvements deducted under the de minimis safe harbor does not trigger SE tax or depreciation recapture under IRC §1250.**

PARTIAL DISPOSITIONS

Before the repair regulations were finalized, if taxpayers replaced structural components of a building or a major part of a piece of equipment, both the original components and the replacement components were capitalized and depreciated. This treatment resulted in taxpayers deducting amounts for phantom items on their returns. The term **phantom item,** as used in this chapter, means an item that was removed to make room for a replacement item.

The IRS issued TD 9689 on September 2, 2014, to provide guidance on dispositions of tangible depreciable property. TD 9689 permits taxpayers to claim a loss on the partial disposition of an item, even if the replaced component is not separately identified on the taxpayer's depreciation schedule. This provision eliminates the simultaneous deduction of both the original and replacement components.[92]

The replacement component must be capitalized.[93] It cannot be treated as a repair deduction.

92. TD 9689, 2014-36 IRB 456.

93. Treas. Reg. §1.263(a)-3(k)(1).

Mandatory Imposition of Partial Disposition Rule

A taxpayer generally may make an **election** to claim a disposition of a portion of any type of MACRS property. However, there are cases when the partial disposition rule is **mandatory**, as in the following situations.[94]

- A partial disposition resulting from a casualty event[95]
- A partial disposition of an asset for which gain (determined without regard to depreciation recapture[96]) is not recognized in whole or in part under a like-kind exchange[97] or eminent domain[98] process
- The transfer of a portion of an asset in a "step-in-the-shoes" transaction[99]
- The sale of a portion of an asset

Planning Considerations Regarding the Partial Disposition Election

Making the partial disposition election provides an immediate tax deduction for the portion of the basis allocable to the asset that was retired. However, practitioners should consider the possible effects of the election if the asset is sold in a subsequent year.

1. The gain from the sale will be higher than it would have been without the election. However, the portion of the gain attributable to allowed/allowable depreciation will be lower. Thus, a portion of the gain **might** be shifted from higher ordinary rates to lower capital gain rates.
2. The entire capital gain may be subject to the net investment income tax, depending on the taxpayer's income level.
3. The gain may increase the taxpayer's AGI to levels that subject the taxpayer to phase outs of various deductions and credits. Common tax provisions subject to phase outs include education incentives, personal exemptions, itemized deductions, and IRA deductions.
4. Although capital gains are taxed for AMT purposes at the same rate that they are for regular tax purposes, ordinary income is not. Both the ordinary income portion of the gain and the taxpayer's other income may be subject to the AMT rates and phase outs.
5. The loss on the disposition is subject to recapture under IRC §1231 for five tax years after the partial disposition treatment is elected. The term **recapture** for this purpose refers to the recharacterization of §1231 gains as ordinary income rather than long-term capital gains.

Note. For a thorough explanation of the IRC §1231 recapture provisions, see the 2013 University of Illinois Federal Tax Workbook, Volume C, Chapter 1: Form 4797. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

94. Treas. Reg. §1.168(i)-8(d)(1).
95. See IRC §165.
96. See IRC §§1245 and 1250.
97. See IRC §1031.
98. See IRC §1033.
99. See IRC §168(i)(7)(B).

Determining Cost of Phantom Components

The benefits of claiming a partial disposition election seem clear, but the application is not so straightforward. Because the component being replaced often is not separately identified in the taxpayer's records, the process of determining the asset's value is complex.

If it is impractical to determine the unadjusted depreciable basis of a component from the taxpayer's records, the IRS allows taxpayers to use **any reasonable method** to determine the value of the replaced component, without the need to undertake expensive valuation studies. The method chosen must be applied consistently to all assets in the same multiple asset account.[100]

The partial disposition regulations suggest the following nonexclusive valuation methods.[101]

- Discounting the replacement cost of an asset to its placed-in-service year cost using the Producer Price Index for Finished Goods or its successor, the Producer Price Index for Final Demand, or other indexes designated by the IRS (These indexes reflect inflation and measure the average change in selling prices over time that producers receive for their products. The IRS has determined that discounting a replacement asset's cost using the Producer Price Index for Finished Goods is reasonable **only if the replacement asset is a restoration** (not a betterment or an adaptation).)

> **Note.** The producer price indexes can be found on the Bureau of Labor Statistics website at **uofi.tax/16b2x3** [www.bls.gov/news.release/ppi.toc.htm].

- Prorating the unadjusted depreciable basis of the multiple asset account based on the replacement cost of the disposed asset to the replacement cost of all assets in the multiple asset account
- Conducting a study to allocate the cost of the individual components of the asset

Manner of Election

Taxpayers make the partial disposition election on their timely filed (including extensions) original federal tax returns in the year of disposition. No election statement is necessary to use this election. The election can be revoked only with the IRS's consent.[102]

100. Treas. Reg. §1.168(i)-8(f)(2)(i).

101. Ibid.

102. Treas. Reg. §1.168(i)-8(d)(2)(ii).