Chapter 2: Capitalization or Repair

IRC §162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business, including amounts paid for incidental repairs. IRC §263(a) denies a deduction for any amount paid for new property or for permanent improvements or betterments that increase the value of any property, or amounts spent to restore property. The regulations are designed to assist in distinguishing between amounts paid to acquire or produce tangible property and amounts paid to improve existing property.

In general, taxpayers should always capitalize amounts paid to acquire or produce tangible property, unless the expenditure qualifies as materials and supplies, or it qualifies under the de minimis safe harbor.

TD 9636, issued in September 2013, contains final regulations that provide guidance on the treatment for amounts paid to acquire, produce, or improve tangible property. Although still allowing for some latitude about what is a repair and what is an improvement, TD 9636 provides several more objective standards. TD 9636 also establishes safe harbors and provides a criterion: whether the action (e.g., the repair) would normally be expected to be performed more than once during a relevant period.

The taxpayer’s accounting method must be in compliance with the new regulations. This extends to all tangible property subject to depreciation now on the taxpayer’s books. It also extends to items that may have been erroneously expensed or depreciated in previous years and are within their recovery periods.

It is estimated that these new regulations will affect about four million taxpayers. They will affect all taxpayers that acquire, produce, or improve tangible property, including small businesses and other for-profit institutions.

Note. Under the due diligence requirement of Circular 230, tax practitioners must conform with TD 9636.
The 13 separate regulations contained in TD 9636 replace the temporary regulations of TD 9564, which were issued in 2011. The new regulations encompass the following subjects.

- Materials and supplies (Treas. Reg. §1.162-3)
- Repairs (Treas. Reg. §1.162-4)
- Rentals (Treas. Reg. §1.162-11)
- Obsolescence of nondepreciable property (Treas. Reg. §1.165-2)
- Leased property (Treas. Reg. §1.167(a)-4)
- Accounting for depreciable property (applicability note modifying Treas. Reg. §1.167(a)-7)
- Retirements (applicability note modifying Treas. Reg. §1.167(a)-8)
- Accounting for MACRS property (Treas. Reg. §1.168(i)-7)
- Capital expenditures, in general (Treas. Reg. §1.263(a)-1)
- Amounts paid to acquire or produce tangible property (Treas. Reg. §1.263(a)-2)
- Amounts paid to improve tangible property (Treas. Reg. §1.263(a)-3)
- Election to deduct or capitalize certain expenses (Treas. Reg. §1.263(a)-6)

**MATERIALS AND SUPPLIES**

Treas. Reg. §1.162-3, as amended by TD 9636, clarifies what are considered materials and supplies that may be expensed.

**GENERAL RULES**

Under Treas. Reg. §1.162-3, materials and supplies are divided into two classes that affect the timing of the deduction.

1. Incidental materials and supplies are those carried on hand and are not usually accounted for by inventory, record of consumption, and so on. The cost of incidental materials and supplies is generally deductible in the year these amounts are paid (or incurred, if the taxpayer uses the accrual method), provided that this clearly reflects taxable income.

2. Nonincidental materials and supplies are those that the taxpayer accounts for by taking a physical inventory or for which a record of consumption is otherwise kept. Nonincidental materials and supplies are generally deductible in the tax year in which they are first used or consumed in the taxpayer’s operations.

**Note.** The treatment of materials and supplies for farmers is governed by Treas. Reg. §1.162-12(a). This regulation allows a farmer to fully deduct amounts expended in conducting the farming business. For farmers, the deduction for nonincidental materials and supplies is limited to such items actually used or consumed during the tax year. Thus, the distinction in the new regulations between incidental and nonincidental materials and supplies is not applicable to farmers.

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1. TD 9564, 2012-14 IRB 614.
DEFINITION OF MATERIALS AND SUPPLIES

According to Treas. Reg. §1.162-3, materials and supplies are any tangible property used or consumed in the taxpayer’s operations, is not inventory, and meets at least one of the following criteria.\(^2\)

1. Is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property (due to the complexity of the definition, “unit of property” is defined in detail later.)

2. Consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer’s operations

3. Is a unit of property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer’s operations

4. Is a unit of property that has an acquisition cost or production cost (determined under IRC §263A) of $200 or less or an amount provided in further guidance in the Federal Register or the Internal Revenue Bulletin

5. Is otherwise identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as materials and supplies for purposes of this regulation

Note. Unlike previous asset classifications, the economic useful life for these purposes is not inherent in the property. Instead, it depends on the use of the property and the expectations of its longevity for the business or the production of income in the hands of and as used by the taxpayer. This period is determined by considering the taxpayer’s experience with similar property, taking into account present conditions and probable future developments. For further details, see Treas. Reg. §1.167(a)-1(b).\(^3\) Additionally, if a taxpayer has an applicable financial statement (AFS) and has depreciated the property for financial accounting purposes, the economic useful life is the same as that first used for depreciation on the AFS.\(^4\) (Applicable financial statements are discussed later.)

Note. For taxpayers eligible for the de minimis safe harbor, the safe harbor (defined later) may be used instead of criteria 3 or 4 to allow expensing. If using the safe harbor instead of criterion 4, the critical threshold per item is either $500 or $5,000, depending on whether the taxpayer has an AFS. In this case, however, all items — materials, supplies, and other assets — qualifying for the safe harbor in the elected taxable year must be expensed under the safe harbor. When either method of expensing could be used, the choice of which to use affects the timing of the deduction. The de minimis safe harbor results in a deduction in the taxable year the cost is paid or incurred, whereas nonincidental materials and supplies treatment are deductible only in the taxable year that the property is first used or consumed.\(^5\)

Amounts expensed under the safe harbor do not count against the IRC §179 limit.

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\(^2\) Treas. Reg. §1.162-3(c)(1).

\(^3\) Treas. Reg. §§1.162-3(c)(4)(i) and 1.167(a)-1(b).

\(^4\) Treas. Reg. §1.162-3(c)(4).

\(^5\) Treas. Reg. §1.162-3(a)(1).