

To Capitalize or Expense What Should You Do?

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As a business owner you have many expenses related to the cost of running your business. But, how do you know if you should expense a purchase or capitalize it? You may not be aware of the rules, but unfortunately you can't expense everything. For example, let's say you buy a vehicle used explicitly for business and know it can not be expensed, so you record it as a fixed asset. Or you buy a computer and again record as a fixed asset, but now you need a keyboard and printer to go with that new PC.

Can you expense it or should it too be capitalized? Here are a few ways to decipher the rules.

First, write a capitalization policy. This should be used as a guide in determining the level expenditures should be capitalized. Issues to consider when developing the capitalization policy include the size and nature of your business, the use of your customary capital items, your level of revenues and expenses, and compliance needs—both tax depreciation report and property tax (if applicable) related. A written capitalization policy can aid in your defense should an examination by the Internal Revenue Service arise.

While there is no confirmed dollar limitation on what should be capitalized—the IRS wants to see all expenditures with expected lives greater than one year to be capitalized. Does this mean that the \$25 keyboard(s) you purchased for your computer(s) should be capitalized and depreciated over the next 5 years? Not necessarily, there are now proposed regulations (not finalized, but a good start for authority) offering some guidance. Included in these proposed regulations are two key points: a de minimis rule and an economic useful life of less than one year.

The de Minimis Rule

The de minimis rule allows you to expense any item that may be potentially capitalized so long as said expense (or a sum of related expenses) does not significantly distort your bottom line. In other words, those expenses do not make up a large percentage of your total expenses, subsequently providing you with extraordinary low income. A good rule of thumb is they should be less than 0.1 percent of your gross receipts for the year, and/or 2% of your total depreciation and amortization expense for the year.

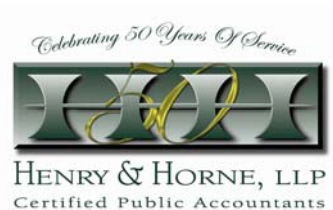
The Economic Useful Life

The economic useful life of less than one year is just that simple. If the items purchased are used and have no value after 12 months then they may be expensed. The only consideration here is timing—

buying in December but consuming in January is frowned upon by the IRS. Again, if those expenses do not distort your bottom line, one could argue for the deduction.

These two areas give you a good place to start when trying to decide whether to capitalize or expense. However, if you have a written capitalization policy in place, utilize some basic parameters when recording your purchases, analyzing each on a case by case basis, and be consistent. If you follow these parameters you should have a solid leg to stand on should the IRS want to contest your expenditures. Outside of the aforementioned parameters, deciding on whether to capitalize or expense can be a tricky subject—never hesitate to contact your Henry & Horne, LLP professional when facing this decision.

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