



REPAIRS OF TANGIBLE PROPERTY USED IN A TRADE OR BUSINESS

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As a fundamental rule, taxpayers are entitled to take deductions only where specifically authorized by the Internal Revenue Code. Thus, because deductions are a matter of “legislative grace,” courts closely scrutinize taxpayers’ claims and reject those that do not clearly respect the letter of the law. Each taxpayer bears the burden of proving his or her entitlement to a deduction, and ambiguities are often resolved in favor of the government. Accordingly, taxpayers should carefully review their maintenance and reconditioning expenditures on property used in a trade or business to determine whether such amounts are deductible or capitalizable. Further, they should retain full and adequate records to substantiate all such costs.

A business expense deduction is generally allowed for all of the ordinary and necessary expenses paid or incurred by a taxpayer during the tax year in carrying on any trade or business. “Incidental repairs” are deductible business expenses for these purposes. However, expenditures that might be similar to repairs, for example, an expenditure that is for a betterment to the property, restores the unit of property, or adapts the property to a new or different use, must be capitalized or charged to

the taxpayer's depreciation reserve rather than deducted. The line between a deductible repair expense and a nondeductible capital expenditure is indistinct; the difference between the two depends upon the factual context surrounding the expenditure. The same outlay that may be treated as a deductible repair in one set of circumstances may be a nondeductible capital expenditure in other situations.

An expenditure is generally deductible as an incidental repair if it is limited to keeping the affected property in its ordinarily efficient operating condition, whereas an amount paid to return a unit of property 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, is a capital expenditure. An expenditure is considered to be a betterment — and thus a capital expenditure — if it ameliorates a material condition or defect that existed before the taxpayer acquired the property (or arose during the production of the property); if it is for a material addition to the property (including a physical enlargement, expansion, extension, or addition of a major component, or a material increase in capacity); or if it is reasonably

expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property.

Repairs incidental to an improvement must be capitalized only if they directly benefit or are incurred by reason of the improvement(s). Expenditures for work performed on depreciable assets that do not qualify as deductible repairs may nonetheless qualify for a bonus depreciation deduction or under the rule that allows you to elect to treat the cost of certain depreciable business assets as a current-year expense. The deductibility of environmental cleanup costs is governed by a special set of detailed rules.

Maintenance expenditures that do not improve the property (i.e., are not paid for a betterment or restoration of the property and do not adapt the property to a new or different use) generally may be deducted. Thus, taxpayers can deduct the costs of various expenditures that alleviate damage or deterioration, so long as the property is not improved. However, taxpayers cannot deduct indirect expenditures (e.g., otherwise deductible repairs) that directly benefit or are incurred by reason of an improvement.

A taxpayer ordinarily can deduct as a repair regularly recurring routine maintenance expenditures that a taxpayer expects to perform to keep the unit of property in its ordinarily efficient operating condition. When such activities happen regularly, an abnormally large expenditure resulting from the same cause is still deductible. On the other hand, a taxpayer must capitalize the cost to replace a major component or a substantial structural part of the unit of property.

There are a host of other factors or considerations that are relevant to the determination of whether a particular expenditure is deductible as a repair:

- Any properly-performed repair adds some value to the property repaired, but that does

not necessarily mean its cost cannot be deducted.

- A common rule of thumb is that the cost of property having a useful life greater than one year must be capitalized. However, the test of deductibility considers whether the expenditure simply kept the property in, or restored it to, an efficient operating condition.

- The size of the expenditure does not control whether it is a deductible repair. Taxpayers have been permitted to deduct expenditures of significant magnitude in comparison to the value of the asset being repaired. Courts have also permitted taxpayers to deduct expenditures that were large in absolute terms if the criteria for a repair expense were satisfied. In addition, expenditures for repairs will not be disallowed merely because they significantly exceed the taxpayer's average annual repair expenditures. On the other hand, a taxpayer cannot deduct his cost to replace an asset on the ground that repairing the asset would be roughly comparable in cost.

- Case law suggests that extensive repairs to an asset shortly after its acquisition have materially altered the asset and are not deductible. Regulations state that taxpayers must capitalize expenditures that ameliorate a material condition or defect that existed before the taxpayer's acquisition of the unit of property. Thus, taxpayers should carefully consider the deductibility of repair and restoration expenditures incurred shortly after the acquisition of an asset.

- Taxpayers cannot deduct involuntary expenditures caused by regulatory requirements or some other governmental action if the expenditures do not fit the criteria for a repair deduction.

- Taxpayers can deduct the cost of materials and labor to conduct repairs, but a self-employed taxpayer may not deduct the value of his own labor to perform repairs.

Special rules apply to repair expenses that are incurred due to a casualty and to leased property. If a taxpayer consistently capitalizes a particular type of expenditure or treats it as a repair, any change to that treatment is generally a change in accounting method that may require IRS permission. Some changes are made by an election and are not considered a change in method of accounting.

Many of the rules in this area are complex and also may be affected by other tax laws.

For this reason, the facts of your situation should be carefully reviewed.

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