

# New Capitalization Rules: Rotable Spare Parts



July 2012

In the final part of our series discussing the new temporary and proposed regulations issued in December 2011, we will discuss the treatment of rotatable spare parts. Several different options for handling such assets are outlined in the temporary regulations. As stated in Article 3, the key to understanding the new regulations is the term “unit of property (UOP).” For property other than buildings, the new regulations adopt a function interdependence test.

## Materials and Supplies

Materials and supplies are defined as tangible personal property other than inventory that falls into one of the following categories:

- › A component acquired to maintain, repair, or improve a UOP owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property
- › Fuel, lubricants, water, and similar items reasonably expected to be consumed within 12 months
- › A UOP that has an economic useful life of 12 months or less, beginning when the property is used or consumed

A UOP that has an acquisition cost or production cost of \$100 or less (or such amount as the IRS may later publish to adjust this figure in the future)

Generally items considered “nonincidental” must be deducted against income in the year in which the items are used or consumed. If the materials and supplies are “incidental” they can be expensed in the year in which they are acquired so long as no record of consumption is kept by the taxpayer and income continues to be clearly reflected even with such immediate expensing.

## Rotable Spare Parts

Rotable spare parts are defined as materials and supplies acquired for installation on a UOP, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation.

Rotable spare parts are treated differently from other materials and supplies. Such items are generally

treated as expenses in the year in which the taxpayer disposes of such parts (if not acquired or produced as part of a single piece of property). This generally results in a deferral of the deduction.

## New Choices Under the Regulations

### Capitalize and Depreciate

- › Under the new regulations taxpayers can choose to capitalize and depreciate the cost of *any* material or supply, including rotatable spare parts. The election is made by capitalizing the amount paid and by beginning to depreciate the cost in that year. The election is made on the timely filed return for the year the asset is placed in service. Once made, the election may be revoked by filing a request for a private letter ruling and obtaining IRS’s consent to revoke the election.

### Optional Method

- › The regulations allow a taxpayer to use the optional method for all of its rotatable spare parts in the same trade or business. The optional method allows Taxpayers to deduct the cost of the rotatable spare parts when the part is first installed. However, if such a part is later removed from a piece of property the taxpayer must include the fair value of the part in income at that point, deducting that amount only when the part is installed in another piece of equipment or is disposed of. The taxpayer also may not currently deduct any amounts paid to maintain, repair or improve the part, but must add them to the basis of the part.

### De Minimis Rule

- › Under this elective *de minimis* rule, a taxpayer does not have to capitalize, nor treat as a material or supply, amounts paid to acquire or produce a UOP (but not inventory or land) or for the acquisition or production of any material or supply (including rotatable parts), if:

(1) The taxpayer has an applicable financial statement (AFS), has written accounting procedures in place at the beginning of the tax year for expensing amounts paid for such property under certain dollar amounts, and treats such amounts as expenses on its AFS in accordance with such written

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accounting procedures. An AFS includes one required to be filed with the Securities and Exchange Commission, or a certified audited financial statement accompanied by an independent CPA's report and used for credit or reporting purposes.

AND

(2) The aggregate of amounts paid and not capitalized under the *de minimis* rule for the tax year are less than or equal to the greater of (1) 0.1% of the taxpayer's gross receipts for the tax year as determined for federal income tax purposes; or (2) 2% of the taxpayer's total depreciation and amortization expense for the tax year as determined in its AFS.

Note that many privately held entities will not have an "applicable financial statement" under these rules and thus will not qualify for the *de minimus* method.

One option would be to expense the amount up to the *de minimis* ceiling amount and then capitalize any amount that is in excess.

The election for is made by deducting the amounts paid to acquire or produce a material or supply in the tax year that the amounts are paid. The election is made on the timely filed return for the year that amounts are paid for the material or supply. Once made, the election may be revoked only by filing a request for a private letter ruling and obtaining IRS's consent to revoke the election.

It should be noted that these regulations do not change the treatment of items under any other provision of the tax code, thus if another provision requires an expense to be capitalized the fact that the above rules would allow expensing would not justify such expensing.

## Conclusion

The new regulations offer more options for the expense related to rotatable spare parts and the most tax efficient strategy will be dependent on specific facts and circumstances.

If you have any questions related to the new temporary regulations or would like to discuss a specific situation related to the temporary regulations, please feel free to contact Jennifer Flinchum ([jflinchum@keitercpa.com](mailto:jflinchum@keitercpa.com)) or your Keiter tax professional for further clarification.

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