

## Tangible Property Regulations: Using the De Minimis Safe Harbor\*

*Guido van der Hoeven, Extension Specialist/Senior Lecturer  
Department of Agriculture and Resource Economics, NC State University*

### Overview

In late 2013, the IRS issued new repair regulations that became effective as of January 1, 2014. Since the new repair regulations were issued, clarifying guidance has been and continues to be issued. The IRS issued Notice 2015-82 in late November 2015, which increased the de minimis amount from \$500 to \$2,500 beginning January 1, 2016. This increased amount is part of the repair regulations that were issued and found in Treas. Reg. § 1.263(a)-1(f)(1), which applies to taxpayers who do not have an applicable financial statement (AFS). Most farmers and ranchers will not have an AFS. The immediate tax benefit is that farmers and ranchers (as well as other business operators) can make the annual election to deduct as a current business expense items that prior to 2014 would have been capitalized and depreciated over the item's tax life. Farmers and ranchers should have a written accounting policy which states that items costing \$2,500 or less will be expensed. This discussion is intended to help farmers and ranchers to make an informed decision about whether or not to make the annual election to use the De Minimis Safe Harbor.

### Application

Under Internal Revenue Code (IRC) § 162 ordinary and necessary business expenses that have a use period of less than one year are generally allowed to be deducted in the year that payment is made by taxpayers. Such farm expenses, for example, may include but are not limited to feed, repairs, supplies, veterinary costs, and business utilities. The de minimis safe harbor now allows taxpayers to deduct in the current year some expenses, which in prior years were required to be capitalized and depreciated, as if they were ordinary and necessary business expenses. Several requirements need to be met in order to employ the de minimis safe harbor:

1. The farmer or rancher must have an invoice that provides detail relative to the purchase he or she wishes to deduct. For example, a farmer purchased an equipment trailer for \$2,400 and had an accounting policy

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(discussed below) that states that items purchased for less than \$2,500 will be expensed. The farmer must have an invoice for the trailer as part of his annual business accounting records.

2. Farmers or ranchers who want to qualify to use the de minimis safe harbor must have an accounting policy (or procedure) in place at the beginning of the tax year. This policy states that items which are at or below an amount (not more than \$2,500 in this case) will either be treated as an expense or have an useful economic life of 12 months or less. This accounting policy should be in writing, and it *must* be in writing if the taxpayer has an AFS and qualifies for the \$5,000 safe harbor amount (most farmers will not qualify, as they don't have an AFS).
3. The de minimis safe harbor is an annual election that is applicable only for a specific tax year (e.g., 2016). The taxpayer makes the election by attaching a statement to the tax return for which the election is made following the guidance found in Treas. Reg. § 1.263(a)-1(f). The statement should include
  - a. Statement of Election under the referenced Treas. Reg. § 1.263(a)-1(f),
  - b. Taxpayer's name and address,
  - c. Taxpayer's federal tax identification number,
  - d. Tax year for which the election is made,
  - e. Statement that taxpayer elects, under Treasury Regulation, all expenditures equal to or less than the elected amount (not to exceed \$2,500 for a farmer or rancher without an AFS) for the tax year ending December 31, 20xx.

The farmer or rancher now has another tool to use to manage his or her income tax liability for a specific income tax year. The use of the de minimis safe harbor also reduces self-employment tax for self-employed individuals. However, farmers and ranchers should consult with competent tax professionals to determine the optimal use of the de minimis safe harbor in their particular business setting. Below are some examples and subsequent discussion that illustrate the benefit and potential pitfalls of using the de minimis safe harbor election.

**Example 1:** Rusty Bucket operates a traditional row-crop farm of 3,500 acres. He does not have an AFS. Rusty is a cash-basis taxpayer and has a written accounting procedure that states that any expenditure of \$2,000 or less will be expensed. In 20xx Rusty bought a pressure washer for \$1,800, a chainsaw for \$650, and a flatbed trailer for \$2,450. The de minimis safe harbor election will allow him to expense two of the three listed items as deductions on his 20xx income tax return. Rusty has individual invoices for these purchases. Because Rusty's accounting procedure limit is \$2,000, even though the flatbed trailer is less than the regulation's \$2,500 de minimis amount, Rusty must capitalize and depreciate the trailer.

**Note:** Prior to January 1, 2014, Rusty was required to capitalize these purchases and depreciate them over 7 years as agricultural assets. Rusty did have IRC § 179 expense election available, which would have resulted in the same income tax outcome.

**Example 2:** Jose Ramirez operates a large vegetable operation. Jose purchased 100 20-foot-long joints of irrigation pipe at a cost of \$80 per joint and a total cost of \$8,000, along with an irrigation pipe trailer for \$1,250. Jose does not have an AFS, is a cash-basis taxpayer, and has a written accounting policy to expense items purchased for \$2,500 or less. Jose plans to make the annual election to expense the irrigation pipe and the trailer against this year's business income on his income tax return.

**Note:** Jose may expense the pipe because, even though the pipe cost a total of \$8,000, the invoice for the pipe states that he bought 100 joints of pipe for \$80 per joint, resulting in the total cost of \$8,000

**Example 3:** Goldi Lockes operates a dairy farm. Goldi purchases replacement heifers for her milking herd. Goldi pays \$750 for each of the 7–9 month old heifers which she then rears to maturity, breeds, and subsequently calves out. Upon entering the milking herd, these cows are kept for about 2.5 years before being replaced. Goldi has an accounting procedure that states that she expenses items that cost \$1,850 or less or have an economic life of 12 months or less. Goldi is a cash-basis farmer and plans to make the annual de minimis election. Goldi has invoices for her heifer purchases.

**Note:** Since the heifers cost less than Goldi’s \$1,850 limit under her accounting procedure and she makes the election, Goldi will expense these heifers in the year of purchase. If Goldi were to capitalize the heifers and depreciate them over their depreciable life of 5 years, the heifers would not be placed into service until they could be bred, which might occur in the subsequent tax year (2016 Farmer’s Tax Guide, page 36). However, for animal-based operations such as dairies, farmers may want to think about capitalizing their replacement animals. See below for discussion.

## Disposition of De Minimis Safe Harbor Expensed Assets

If farmers or ranchers make the de minimis election in a prior year and subsequently dispose of the property, they must report the income as ordinary income, but it is not subject to self-employment tax. The reporting of this income is accomplished, for income tax purposes, on IRS Form 4797 (Sale of Business Assets), specifically on Part 2, which treats this income as ordinary income subject to the progressive income tax rates.

**Example 4:** Jose, from Example 2, sells the irrigation pipe that he expensed using the de minimis safe harbor election after two years of use. He must report the sale on Part 2 of IRS Form 4797, which will result in a gain because his cost basis in the pipe is zero. This gain will be subject to ordinary income tax rates but not to self-employment tax.

**Example 5:** Goldi, from Example 3, begins to sell the replacement heifers as cull cows beginning 2 years after they were placed into service. Goldi received an average \$1,250 per cull cow, as they are now larger mature animals. Like Jose, Goldi must report these animal sales on Part 2 of IRS Form 4797, which will treat the entire \$1,250 gain per animal as ordinary income.

**Note:** This example illustrates that making the de minimis safe harbor election may not be in the taxpayer’s long-run best interest. In Goldi’s case, one might assume that there is \$500 of capital gain; however, this is not the case, because the de minimis safe harbor creates a situation in which an asset is sold in a disposition; the Treasury Regulations require that this income be subject to ordinary taxation.

## A case for not making the annual De Minimis Safe Harbor elections.

If Goldi's dairy operation was of sufficient scale that she was selling many cull cows that had been purchased as replacement heifers, Goldi may indeed want to not elect the de minimis safe harbor. Instead, Goldi might be better off capitalizing these heifers, using the IRC section 179 expense election to accomplish the same income tax outcome in the year the heifers are placed into service. Then, upon subsequent sale as a cull cow, she would recapture the depreciation (the expensed amount under section 179) but recognize the \$500 as an IRC section 1231 gain, which—if a net gain—will be treated as capital gain and taxed under preferential income tax rates of 0%, 15%, or 20% depending on the taxpayer's income.

**Example 6:** Goldi, from Examples 3 and 5, chose not to use the de minimis safe harbor rules because, based on her business model, she would benefit from partial capital gain treatment under IRC section 1231 when she sells cull cows that had been purchased as replacement heifers. Goldi consistently sells 60 cull cows annually, which she purchased as replacement heifers. She sells these animals as cull cows for an average of \$1,250. In the year Goldi placed these heifers into service, she capitalized the \$750 per heifer and used IRC section 179 expensing to reduce her income and self-employment tax.

In the year of disposition, Goldi recaptures the \$750 of depreciation allowed subject to ordinary income tax rates. However, the \$500 of gain (sale price above initial purchase price) is an IRC section 1231 gain, which is treated as a capital gain if it is a net gain. Since Goldi averages 60 cull cows, she has approximately \$30,000 of gain which is subject to the preferential capital gain income tax rates. If Goldi's taxable income is in the 15% ordinary income tax bracket, this \$30,000 of income escapes taxation and is "income tax free." Similarly, if Goldi's taxable income is within the 25–35% tax brackets then the 15% rate of tax on capital gains would apply. Therefore, it is prudent for farmers and ranchers who have a business model similar to that which is described in the Goldi Lockes example to have a discussion with their tax professional to determine the best long-term decision relative to using the de minimis safe harbor election.

## IRS Publications

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## Additional Topics

This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities, to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets, and additional information related to agricultural income tax, please see [RuralTax.org](http://RuralTax.org).

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