How the IRS Views Your Stock of Replacement Parts

Stuart W. Margolis, CPA, MT and Brian L. Enverso, CPA, MT, CVA

It is not uncommon for printing machines to have malfunctioning parts from time to time. Sometimes it can be quickly resolved while on other occasions a particular part may have to be reordered and replaced. We all know that machine downtime can be extremely costly and in some cases it can be devastating. Therefore a printer's ability to identify these issues and take corrective action quickly is critical to the vitality of the business. In planning ahead, printers typically purchase additional spare parts to keep on hand just in case a need evolves. When accounting for the cost of these spare parts, most of the printing world expenses these costs in the period in which the spare parts were purchased. However, the IRS would rather see you capitalize these costs and expense it later when you actually use it. As a result, Uncle Sam is reeking havoc on some printers that do too good of a job in managing their spare parts.

The law in this area (Treasury Regulation Section 1.162-3) states that anyone carrying materials and supplies can deduct the cost of these items only as they are used. For example, if you purchased $40,000 in spare parts during 2006, but only actually used $10,000 worth of parts during that year, your 2006 deduction is limited to $10,000. The remaining $30,000 of spare parts may be deducted later as they are used.

Now before you start thinking that you have been doing something wrong, let's consider the exception to this general rule. The law also states that items which are incidental to your business can be deducted at the time of purchase if two conditions are met: (1) no physical inventory at either the beginning or ending of the tax year can be taken, and (2) no record of consumption can be maintained. It seems simple enough to comply with the first part of the exception and not take a physical inventory of spare parts. However, this in conjunction with the second part of the exception doesn't seem that practical because if you don't

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keep an eye on your spare parts, how will you know when to reorder? So what do we mean by a "record of consumption"?

There is no clear answer as to what constitutes a record of consumption. In fact, the law does not explicitly define the elements of a "record of consumption" per se. What seems to be the issue at hand is the recording and tracking of each item purchased and used. Even if per unit costs are not evident, the IRS will attempt to put dollar figures on it.

Software Programs:

The first dead give away is a computer database, which itemizes your spare parts on hand along with their associated cost. Today's software packages possess the ability to extract, sort and report information in various facets. The IRS has taken the position that if you maintain spare parts log using software, which has the ability to report on how much you have purchased and used within a period of time, you are maintaining a record of consumption. Even if you don't use or even know how to use the complete functionality of the program, the IRS will deem the program a record of consumption if it has the ability to report on the cost and usage of your spare parts.

Hand Written Logs:

Another clue that the IRS looks for are written logs, which also contain purchase dates, cost and dates of usage. By the way, it's also worth mentioning that even if upper management is not aware that such a tool exists within the company, the IRS will still hold the company's feet to the fire simply because a record of consumption exists and has the potential of being relied upon.

In conclusion, be careful how you track items that are only incidental to your business. Common sense says not to purchase items too far in advance before you use it. Remember the concept of "Just-In-Time" management was developed to facilitate optimum workflow with minimal costs. On the other extreme, you may find your stock of replacement parts stock scrutinized if under an IRS audit.

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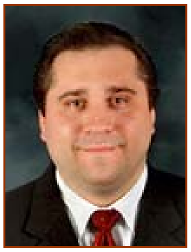

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