What is a Capitalization Policy?

DECAL
Thriving Child Care
Business Academy

How to organize and implement a capitalization policy to best benefit your small business

Though creating and employing a capitalization policy for your child care business may seem complicated, there are many worthwhile benefits to doing so, not the least of which is complying with US Internal Revenue Service Requirements.

A good capitalization policy can help your business approach large expenditures with consistency and allows you to categorize many purchases as expenses, which can be deducted in a single year. Keep reading to learn more about what a capitalization policy is, why you need one, and what to include in your policy.

What is a Capitalization Policy?

In accounting, you typically treat any large purchases or those items with a life of more than one year (like a dishwasher or furniture) as capital expenses. This means that even though you paid for it this year, you will need to deduct the cost over several years (this is called depreciation, you can learn more about it here). For example, let's say you purchased a couch used exclusively for your child care business for $700. Even though you paid for it this year, you would only be able to deduct $100 a year over seven years. That means that even though you spent the money this year, you'll pay extra taxes on it.

This could be a hardship for small businesses, so the IRS created a "safe harbor" that provides an exception, if you have a capitalization policy in place. With a capitalization policy you can say that any item you buy which is less than $2,500 can be treated as a current year expense, even if it has a life of more than one year. In other words, the policy allows you to skip depreciation for items less than $2,500 and deduct them this year, keeping your taxes lower.

How to Create a Capitalization Policy for your Business

Typically, most small businesses opt to create a capitalization policy at the highest limit: $2,500. You can set it lower, but this level allows you the greatest advantage on your taxes and in your bookkeeping.

Creating a policy is very simple and takes only three steps:

Step 1: Create the Policy

The following items should be included in a capitalization policy:

- **Purpose:** Clearly state the purpose of the capitalization policy, which in this case is to establish the minimum cost (capitalization amount) for recording capital assets in the company's annual financial statements.
- **Capital Asset Definition:** Provide a clear definition of what constitutes a "Capital Asset." Typically, you'll want to include items with a useful life of more than one year and a cost of $2,500 or more.
- **Capitalization Thresholds:** Set the threshold amount for minimum capitalization.
- **Capitalization Method and Procedure:** Outline the method and procedure for capitalizing assets.
- **Recordkeeping:** Specify the recordkeeping requirements.

Here's an example:

> **1. Purpose:** The purpose of this capitalization policy is to establish guidelines for the recognition and recording of capital assets in the company's financial statements, ensuring consistent and appropriate treatment of these assets.
> **2. Capital Asset Definition:** A capital asset is defined as a tangible or intangible asset that meets the following criteria:
> a) It has a useful life that extends beyond 12 months.
> b) It was acquired or produced for a cost exceeding $2,500.
> **3. Capitalization Thresholds:** The threshold for capitalization shall be set at $2,500. All assets meeting or exceeding this cost shall be capitalized, while assets below this threshold shall be expensed in the period of acquisition.
> **4. Capitalization Methodology and Procedures:** Capital assets shall be recorded at their historical cost, including all costs directly attributable to bringing the asset to its intended use. Tangible assets falling below the capitalization threshold shall be recorded as expenses in the financial statements of the period in which they are acquired.
> **5. Depreciation and Amortization:** Capital assets with finite useful lives shall be depreciated or amortized using appropriate methods over their estimated useful lives. The depreciation or amortization expense shall be recognized in the financial statements on a systematic basis.
> **6. Recordkeeping:** All supporting documentation, including invoices, contracts, and relevant financial records, substantiating the acquisition cost of capital assets, shall be retained for a minimum of four years from the date of disposal or retirement.
> **7. Review and Compliance:** This capitalization policy shall be periodically reviewed to ensure its relevance and effectiveness.

Step 2: Sign the Policy

Sign on the bottom of the policy. It is important to have as a record in case of IRS audit, so even if you are a sole proprietor with you as the only employee, you should still sign it.

Step 3: File your Policy

Keep both a paper and an electronic copy of the policy, just in case you need it in an audit. This can be as simple as keeping a paper copy in your files and taking a photo of it for a digital version.

Even though it may seem like some extra steps, creating a capitalization policy will allow you to legally expense many more items and have a clear reason for doing so if you are ever audited by the IRS.

Additional Resources

If you have questions or need help, assistance is available.
GaPDS Website
DECAL Thriving Child Care Business Academy Website
To Find Other Study Guides: Click on Resources on the Academy home page
To Find Training: Click on Trainings on the Academy home page
To Register for Training: Click on Schedules & Registration on the Academy home page
To Sign Up for Study Groups: Fill out the Intake Assessment
For questions about coaching or study groups: Email GAcoaching@civstrat.com
To Find Other ECE Resources: Visit the DECAL Website
For General Questions about the Academy: Email thriving@decal.ga.gov
For More Information:
Family Child Care Learning Home Rules and Regulations
Child Care Learning Center Rules and Regulations