

# Form 3115 Change in Accounting Method: Navigating the IRS Repair Regulations

WEDNESDAY, MAY 4, 2016, 1:00-2:50 pm Eastern

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# Form 3115 Change in Accounting Method

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May 4, 2016

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## *Agenda*

1. Discussion of Repair Regulations and requirement to file Form 3115
2. Completing Form 3115 change in accounting method and required calculations
3. Implementation of change in accounting method regulations and Rev. Proc. 2015-20 relief from Form 3115 requirements

*Discussion of repair  
regulations and requirement  
to file Form 3115*

## *Outline*

Overview of tangible property regulations

Repair regulations

- De minimis election
- Materials and supplies
- Repairs v. capital improvement

Disposition regulations

- Identification of asset for disposition purposes
- Full and partial asset dispositions

Industry Issue Resolution (“IIR”) guidance

Requirements to adopt new rules

## *Tangible property regulations*

Generally effective for tax years beginning on or after January 1, 2014

- Taxpayers could elect to “early adopt” the provisions prior to 2014

Two different Regulation packages

- “Repair Regulations” issued September 2013
  - Treatment of materials and supplies
  - New de minimis safe harbor
  - Identification of “unit of property” for repair and maintenance expenditures
  - Differentiation between deductible repairs and capital improvements
- “Disposition Regulations” issued August 2014
  - Identification of assets for disposition purposes
  - Treatment of full asset dispositions
  - Treatment of partial asset dispositions - mandatory and elective

Rev. Proc. 2015-56 issued November 2015 provides IIR guidance for the retail and restaurant industries

## *Impact of regulations*

Provided new rules that taxpayers must follow in accounting for costs associated with fixed assets

Addressed every phase of asset life cycle

- Purchase
- Repair and maintenance
- Disposition

Impacted all taxpayers with fixed assets

Required many taxpayers to take affirmative steps to comply with new rules

- Form 3115 to change taxpayer's existing accounting methods
- Elections to take advantage of certain provisions

## *Highlights in new repair regulations*

New categories and criteria for classifying costs associated with fixed assets

- De minimis expenditures
- Materials and supplies
- Deductible repairs v. capital improvements
  - Treatment of transaction costs and other costs associated with capital improvements

## *De minimis safe harbor election*

Allows taxpayers to deduct costs for tax purposes that are deducted for book purposes under capitalization policies and procedures

Requires book-tax conformity for amounts covered by election

Different thresholds and requirements based on whether taxpayer has Applicable Financial Statement (“AFS”)

- Financial statement filed with SEC,
- Certified audited financial statement used for non-tax purposes (i.e., reports to creditors or shareholders) or
- Financial statement required to be filed with government agency

## *De minimis safe harbor*

### Requirements for capitalization policies

- Must be in place as of the beginning of the tax year
- Must be in writing if taxpayer has an AFS
- Must provide that amounts paid for an item with a cost below a specified threshold or a useful life of 12 months or less are deducted

### Dollar threshold

- Safe harbor limitations:
  - \$5,000 for taxpayers with AFS;
  - \$2,500 for taxpayers without an AFS
- Threshold applies on per-invoice or per-item basis

## *Materials and supplies: Definition*

Tangible property used or consumed in taxpayer's operation that is not inventory and is -

- Component used to maintain, repair or improve tangible property;
- Fuel, lubricants, water and similar items reasonably expected to be consumed in 12 months or less;
- Unit of property with an economic useful life of 12 months or less; or
- Unit of property with a cost of \$200 or less

Rotable spare parts

- Materials and supplies that are installed in unit of property, removed and repaired and re-installed

Temporary spare parts

- Materials and supplies used temporarily until new or repaired part can be installed

## *Accounting for materials and supplies*

Incidental materials and supplies deducted in year purchased

- Incidental materials and supplies are carried on hand and no physical inventories are taken and no record of consumption kept

Non-incidentals materials and supplies deducted in year used or consumed

Rotable and temporary spare parts used or consumed (i.e., deductible) when disposed

- Optional method allows taxpayer to account for rotables when installed, removed, repaired and re-installed

## *Capital improvements*

Section 263(a): Taxpayers must capitalize amounts paid for new buildings or permanent improvements or betterments to property

Amounts required to be capitalized include -

- Invoice price;
- Transactions costs that are inherently facilitative; and
- Work performed prior to asset being placed in service

Direct costs of improvements and indirect costs incurred “by reason of the improvement” must be capitalized

## *Repairs v. capital improvements*

Treas. Reg. § 1.263(a)-3: A unit of tangible property is improved if the amounts paid

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1. Are for a betterment to the unit of property;
2. Restore the unit of property; or
3. Adapt the unit of property to a new or different use

Amounts that are not defined as improvements treated as deductible repairs

## *Unit of property – Buildings*

Each building and structural components is a single unit of property

Expenditures must also be analyzed against building structure and the following building systems to identify any improvements:

- HVAC system;
- Plumbing systems;
- Electrical systems;
- Escalators;
- Elevators;
- Fire-protection and alarm systems;
- Security systems; and
- Gas distribution systems

## *Unit of property – Other assets*

General rule: Functional interdependence

- Assets are functionally interdependent if placing in service of one component is dependent on placing in service of the other component by the taxpayer

Special rules:

- Plant property used to perform industrial process
  - Must look at each component of machinery or equipment that performs discrete and major function
- Leased property
  - Look at portion of building or other property/system that is subject to the lease

## *Betterment of unit of property*

Taxpayers are required to capitalize as betterments amounts that -

- Ameliorate a material condition or defect that was present prior to taxpayer's acquisition of the property;
  - Is the taxpayer repairing damage or wear caused by prior owner?
- Result in a material addition or increase in capacity of the unit of property; or
  - Is the taxpayer adding to the original property or the original capacity of the property?
- Are reasonably expected to materially increase the productivity, efficiency, strength, quality or output of the unit of property
  - Is the taxpayer materially improving the property relative to when the property was placed in service?

## *Restoration of unit of property*

Amounts required to be capitalized as restorations -

- Amounts paid for the replacement or restoration of property for which the taxpayer recognized a loss or took a basis adjustment;
- Amounts that return the unit of property to ordinarily efficient operating conditions after property has deteriorated into state of disrepair;
- Amounts that rebuild the unit of property to a like-new condition after the end of its class life; or
- Amounts that are for the replacement of a part or combination of parts that comprise a major component or substantial structural part of unit of property
  - Qualitative test: What are the major components of the unit of property?
  - Quantitative test: How much of the physical structure of the unit of property was repaired or replaced?

## *Adaption of unit of property to new or different use*

Amount is paid to adapt a unit of property to a new or different use where the adaptation is not consistent with the taxpayer's ordinary use of the unit of property when originally placed in service by taxpayer

- Need to look at taxpayer's anticipated use of the property at the time property was placed in service
- In leased property situations, look to landlord's use of the property, not tenant's use

## *Highlights in new disposition regulations*

### Definition of a disposition

- Asset is permanently withdrawn from use in taxpayer's trade or business
- Includes sale, exchange, retirement, abandonment or destruction of an asset

### Definition of an "asset" for disposition purposes

- Each building is treated as an asset
- Each condominium or cooperative unit is a separate asset
- Each tangible property asset classified in a different asset class under Rev. Proc. 87-56 is a separate asset
- Each improvement placed in service after the original asset is a separate asset

## *Accounting for dispositions*

Taxpayers are required to recognize full asset dispositions

Recognizing partial dispositions is generally elective

- Taxpayers file partial disposition election in year of disposition
- Partial dispositions arising from casualty losses, involuntary conversions, non-recognition exchanges and partial asset sales NOT elective
- Recognizing partial dispositions will require any repair or replacement costs to be capitalized as a restoration

Taxpayer recognizes gain or loss upon disposition of an asset

- Amount of gain or loss recognized depends on type of disposition

Taxpayer ceases claiming depreciation deductions at the time of disposition

## *Retail/restaurant IIR guidance*

Rev. Proc. 2015-56 provides a safe harbor method for applying the Tangible Property Regulations to costs incurred in connection with a qualifying remodel

- 75% of qualified costs treated as currently deductible;
- 25% of qualified costs capitalized

Safe harbor encompasses both repairs and partial dispositions

Applies to *qualified remodel-refresh costs* incurred by a *qualified taxpayer* on a *qualified building*

- Excluded costs are analyzed under Tangible Property Regulations and associated guidance

## *Retail/restaurant IIR guidance (continued)*

Requirements to apply safe harbor -

- Taxpayer must be engaged in retail or restaurant business or lease a building to a taxpayer engaged in retail or restaurant business
- Taxpayer must have an AFS
- Taxpayer must account for building assets and improvements in General Asset Accounts (“GAA”)
- Taxpayers cannot claim partial disposition deductions for qualified buildings and must reverse any partial dispositions claimed in prior years to apply the safe harbor retroactively
- Taxpayer must document remodel-refresh costs subject to the safe harbor similar to Appendix to Rev. Proc. 2015-56
- Once adopted, safe harbor applies to all qualifying costs until taxpayer obtains consent to change method
- Rev. Proc. 2015-56 provides that changes required to adopt retail/restaurant safe harbor are changes in method of accounting

## *Adoption of new tangible property regulations*

Taxpayers must apply the new rules for tax years starting on or after the effective date of the Regulations (1/1/2014)

Regulations provide that a change to comply with the new rules is a change in accounting method under Sections 446 and 481

- Accounting method changes include any changes in the timing of reporting an item of income or deduction
- Adopting the new rules will change when and how a taxpayer reports costs on its tax return - i.e., deduction when paid, deduction when used or consumed, capitalized and depreciated

Regulations specify certain aspects of the rules that are adopted and applied by filing an election - i.e., de minimis safe harbor, partial asset dispositions

- These provisions apply only if, and when, taxpayer elects

## *Method of accounting v. election*

Methods of accounting must be consistently applied

- Taxpayer files a Form 3115, *Application for Change in Accounting Method*, to change their method of accounting
- Taxpayers must apply the method in future years with no ongoing filing obligation unless taxpayer requests consent to change
- May allow re-classification of prior year costs (Section 481(a) adjustment)

Elections must be made on an annual basis and apply only to years in which election is made

- No opportunity to re-classify prior year costs
- Late and missed elections remedied through letter ruling requests under §§ 301.9100-2 and 301.9100-3

*Completing Form 3115  
change in accounting  
method and required  
calculations*

*Form 3115 and  
accounting method change  
procedures*

## *Revised Form 3115*

Revised December 2015

Incorporates changes made in Rev. Proc. 2015-13

- Question 7 - audit protection if under exam

Question 16 - legal basis

## *Rev. Proc. 2015-13 and Rev. Proc. 2015-14*

Rev. Proc. 2015-13 - Method Change Procedures for Automatic and Non-Automatic Changes

- Updates and revises general procedures under Section 446(e) to obtain consent to change a method of accounting
- Supersedes Rev. Proc. 97-27 and Rev. Proc. 2011-14

Rev. Proc. 2015-14 - List of Automatic Accounting Method Changes

## *Rev. Proc. 2011-14*

Transition relief - May still be used for years of change beginning before January 1, 2015

Taxpayers may want to make changes under the tangible property or dispositions regulations where the scope limitations of Rev. Proc. 2011-14 are waived if they:

- Are under examination,
- Changed their method of accounting for the same item (or applied for consent to change its method for the item regardless of whether it implemented the change) during any of the five taxable years ending with the year of change, or
- The year of change is the taxpayer's final year of its trade or business.

Not able to use Rev. Proc. 2011-14 for remodel-refresh safe harbor changes

## *Changes in eligibility to file under Rev. Proc. 2015-13*

Most significant changes involve taxpayers under IRS examination

- File anytime
- No longer receive taxpayer-friendly terms and conditions unless Form 3115 filed within a window period or meets certain exceptions
  - If not,
    - No audit protection
    - Two year spread period for unfavorable Section 481(a) adjustment

## *Filing method changes while under IRS exam*

Exceptions that permit audit protection and four-year spread of unfavorable Section 481(a) adjustment:

- “Three-month window”: Applies to applications filed in the period beginning on the 15th day of the 7th month of taxpayer’s tax year and ends on the 15th day of the 10th month of the taxpayer’s tax year
  - For a calendar year taxpayer, it is the period between July 15 through October 15
- “120 day window”: Applies to applications filed in the 120 day period following end of an IRS exam, regardless of whether new cycle has begun
- Present method not before director: Applies to a change from a clearly permissible method or from an impermissible method where that method was adopted subsequent to the years under exam
- New member of a consolidated group: Applies to certain taxpayers in CAP
- Change results in a taxpayer favorable (“negative”) Section 481(a) adjustment: Applies if adjustment is negative in year of change and would have been in years under exam. One year pickup of favorable Section 481(a) adjustment

*Selected issues in making  
accounting method changes*

## *Partnerships and S corporations*

For tax year(s) under exam,

- Entity, including an LLC, treated as a partnership or S corporation
- Has an issue under consideration if the same item is an issue under consideration in a exam, before Appeals, or before a federal court for a partner, member, or shareholder's federal income tax return

No longer prohibited from filing a Form 3115 if is an issue under consideration in a exam, before Appeals, or before a federal court for a partner, member, or shareholder's federal income tax return

## *Form 3115, Page 1 – Selected items*

### Applicants

- Entities eligible to change on one application
- Identical present and proposed methods requirement

### Year of Change

- First taxable year that proposed method will be used on the federal income tax return

## *Form 3115, Page 1 – Multiple method changes*

Multiple automatic method changes may be made on one Form 3115 if specifically permitted in Rev. Proc. 2015-14

- Must provide all the information required for each change
  - Depreciation (DCN 7) can be combined with dispositions changes 200, 205, 206, 207
  - Certain dispositions changes can be combined with other depreciation/dispositions changes
  - Certain UNICAP changes can be combined with “repairs” changes under section 10.11 of Rev. Proc. 2015-14 and a disposition change under DCN 199
  - Remodel-refresh safe harbor can be combined with changes to revoke partial disposition election (DCN 221) and change in determining asset disposed of (DCN 200, 205, 207)

## Section 10.11(3) – Materials and supplies

Changes	Final regulations	Designated automatic accounting method change number
Change to deducting amounts paid or incurred to acquire or produce non-incidentals materials and supplies in the taxable year in which they are first used in the taxpayer's operations or consumed in the taxpayer's operations	1.162-3(a)(1) and 1.162-3(c)(1)	186
Change to deducting amounts to acquire or produce incidentals materials and supplies in the taxable year in which paid or incurred	1.162-3(a)(2) and 1.162-3(c)(1)	187
Change to deducting amounts paid or incurred to acquire or produce non-incidentals rotatable and temporary spare parts in the taxable year which the taxpayer disposes of the parts	1.162-3(a)(3) and 1.162-3(c)(2)	188
Change to the optional method of accounting for rotatable and temporary spare parts	1.162-3(e)	189

## Section 10.11(3) – Repairs and maintenance and improvements to tangible property

Changes	Final regulations	Designated automatic accounting method change number
<p>Change to deducting amounts paid or incurred for repair and maintenance, including a change, if any, in identifying the unit of property or, in the case of a building, identifying the building structure or building systems for purposes of making the change to deducting the amounts</p> <p>*Includes Routine Maintenance Safe Harbor</p>	<p>1.162-4, 1.263(a)-3(e), and 1.263(a)-3(e)(2)</p> <p>1.263(a)-3(i)</p>	<p>184</p>
<p>Change to capitalizing amounts paid or incurred for improvements to tangible property and, if depreciable, to depreciating such property under section 167 or 168, including a change, if any, of identifying the unit of property or, in the case of a building, identifying the building structure or building systems for purposes of making the change to capitalizing the amounts</p>	<p>1.263(a)-3, 1.263(a)-3(e), and 1.263(a)-3(e)(2)</p>	<p>184</p>
<p>Change to the optional regulatory accounting method to determine whether amounts paid or incurred to repair, maintain, or improve tangible property are treated as deductible expense or capital expenditures</p>	<p>1.263(a)-3(m)</p>	<p>185</p>

## Section 10.11(3) – Transaction costs

Changes	Final regulations	Designated automatic accounting method change number
Change by a dealer in property to deduct amounts paid or incurred for commissions and other transaction costs that facilitate the sale of property	1.263(a)-1(e)(2)	190
Change by a non-dealer in property to capitalizing amounts paid or incurred for commissions and other costs that facilitate the sale of property	1.263(a)-1(e)	191

## *Section 10.11(3) – Acquisition and production costs*

<b>Changes</b>	<b>Final regulations</b>	<b>Designated automatic accounting method change number</b>
Change to capitalizing amounts paid or incurred to acquire or produce property, and if depreciable, to depreciating such property under section 167 or 168	1.263(a)-2	192
Change to deducting amounts paid or incurred in the process of investigating or otherwise pursuing the acquisition of real property	1.263(a)-2(f)(2)(iii)	193

## *Section 10.13 – Remodel-refresh safe harbor method*

Changes	Designated automatic accounting method change number
Change to the remodel-refresh safe harbor method of accounting, including the making of a late general asset account election	222

## Dispositions changes – Sections 6.36 and 6.37

Appendix section	Change	Final regulations	DCN
6.36	Change to comply with Treas. Reg. section 1.167(a)-4 for leasehold improvements in which the taxpayer has a depreciable interest at the beginning of the year of change	1.167(a)-4	199
6.37	<p>Permissible to permissible methods for depreciation of MACRS property</p> <ul style="list-style-type: none"> <li>• Change in grouping assets in general asset accounts</li> <li>• Change in method of identifying which assets, or portions therefore, have been disposed of in general asset accounts</li> <li>• Change in determining unadjusted depreciable basis of disposed asset, or portion, from one reasonable method to another in general asset accounts</li> <li>• Change from single asset accounts to multiple asset accounts, or vice versa</li> <li>• Change in grouping asset in multiple asset accounts</li> <li>• Change in determining unadjusted depreciable basis of disposed asset in in a multiple asset account or disposed portion of an asset from one reasonable method to another</li> <li>• Change in method of identifying which assets in a multiple asset account, or portion thereof, have been disposed of from one method to another specified in Treas. Reg. section 1.168(i)-(g)(1)( or (2)</li> </ul>	<p>1.168(i)-1(c)</p> <p>1.168(i)-1(j)(2)</p> <p>1.168(i)-1(j)(3)</p> <p>1.168(i)-7</p> <p>1.168(i)-7(c)</p> <p>1.168(i)-8(f)(2) or (3)</p> <p>1.168(i)-8-(g)</p>	200

## Dispositions changes – Sections 6.38

Appendix section	Change	Final regulations	DCN
6.38	<ul style="list-style-type: none"> <li>• Change in determining asset disposed of for building or structural component not in a general asset account</li> <li>• Change in determining unadjusted depreciable basis of disposed building or structural component, or portion thereof, in a multiple asset account</li> <li>• Change in method of identifying which building or structural component in a multiple asset account, or portions thereof, have been disposed of</li> <li>• Change from depreciating a disposed building or structural component, or portion thereof, to recognizing gain or loss when taxpayer continues to depreciate the asset or portion disposed of in prior year</li> </ul>	<p>1.168(i)-8(c)(4)</p> <p>1.168(i)-8(f)(2) or (3)</p> <p>1.168(i)–8(g)</p> <p>1.168(i)-8(h)(1)</p>	205

## Dispositions changes – Sections 6.39 and 6.40

Appendix section	Change	Final regulations	DCN
6.39	<ul style="list-style-type: none"> <li>Change in determining asset disposed of for property other than building or structural component not in a general asset account</li> <li>Change in determining unadjusted depreciable basis of disposed property other than building or structural component, or portion thereof, in a multiple asset account</li> <li>Change in method of identifying which property other than building or structural component in a multiple asset account, or portions thereof, have been disposed of</li> <li>Change from depreciating disposed property other than a building or structural component, or portion thereof, to recognizing gain or loss when taxpayer continues to depreciate the asset or portion disposed of in prior year</li> </ul>	<p>1.168(i)-8(c)(4)</p> <p>1.168-8(f)(2) or (3)</p> <p>1.168(i)–8(g)</p> <p>1.168(i)-8(h)(1)</p>	206
6.40	<ul style="list-style-type: none"> <li>Change in determining asset disposed in a general asset account</li> <li>Change in method of identifying which assets, or portions thereof, have been disposed of in a general asset account</li> <li>Change in determining unadjusted depreciable basis of disposed asset, or portion thereof, in a general asset account</li> </ul>	<p>1.168(i)-1(e)(2)(viii)</p> <p>1.168(i)-1(j)(2)</p> <p>1.168(i)-1(j)(3)</p>	207

## *Section 6.43 – Revocation of partial disposition election under the remodel-refresh sale harbor method*

Changes	Designated automatic accounting method change number
Change to revoke a partial disposition election related to a qualified building for which the taxpayer uses the remodel-refresh safe harbor method of accounting  *treated as method of accounting only for first or second taxable year beginning after December 31, 2013	221

## *Form 3115, Question 14 – Description of present and proposed methods*

Description of item(s) being changed and present and proposed methods of accounting for changes under section 10.11 of Rev. Proc. 2015-14 must include the following:

- Citation to paragraph of final regulations that provides for the proposed method(s) to which the taxpayer is changing.
- Detailed description of the unit(s) of property, building structure(s), or building system(s) under the present and proposed methods of accounting, if applicable
- To the extent a change involves depreciation under Sections 167 or 168 must complete Schedule E of Form 3115.

New statements required for all method changes:

- whether taxpayer claimed any federal tax credit for item being changed
- what method other members of a consolidated group use for the item being changed
- If Schedule M-3 filed with last tax return or will be with next tax return, state whether proposed change is related to the adoption of IFRS for financial statement purposes

## *Form 3115, Question 16 – Legal basis*

Only required for certain changes:

- Dispositions - only certain changes made under the following change sections
  - Section 6.37, DCN 200 (permissible to permissible methods for depreciation of MACRS property)
  - Section 6.38, DCN 205 (disposition of a building or structural component)
  - Section 6.39, DCN 206 (disposition of tangible depreciable assets other than an building or its structural components)
  - Section 6.40, DCN 207 (dispositions of tangible depreciable assets in a general asset account)
- UNICAP section 11.09, DCN 194 (change to reasonable allocation method)
- Depreciation section 6.01, DCN 7 (impermissible to permissible method)

## *Form 3115, Schedule E*

Only required for certain changes, such as changing depreciation methods, or changes to depreciate assets not previously depreciated (e.g., change from treating costs as repairs to treating as improvements)

Completing this schedule is necessary to comply with the requirement to provide the legal basis for the method change

## *Form 3115, Question 11 – Prior accounting method changes*

An otherwise automatic accounting method change may not be automatic if a taxpayer changed, or applied for consent to change (regardless of whether it implemented that change), its method of accounting for the same item during any of five prior taxable years

Waived for “repairs” and dispositions changes for tax years beginning before January 1, 2015

Waived for remodel-refresh safe harbor changes and revocation of partial disposition election made for first or second taxable year beginning after December 31, 2013

Considerations for method change under Rev. Proc. 2015-20

# *Section 481(a) adjustments*

## *Form 3115, Part IV – Section 481(a) adjustment*

“Catch up adjustment” - prevents amounts from being duplicated or omitted

### Calculation

- No statute of limitations; generally as long as taxpayer has used method
- Certain changes made with modified Section 481(a) adjustment
  - In general, only amounts paid or incurred in taxable years beginning on or after January 1, 2014 are taken into account

Certain changes are made by taking the entire adjustment into account in the year of change

- Revocation of partial disposition election under the remodel-refresh safe harbor
- Certain dispositions method changes

Higher de minimis exception (unfavorable amount less than \$50,000)

## *Modified Section 481(a) adjustment*

The following changes require a modified Section 481(a) adjustment:

- Material and supplies
  - deducting non-incidentals materials and supplies when used or consumed
  - deducting incidental materials and supplies when paid or incurred
  - deducting non-incidentals rotatable and temporary spare parts when disposed of (Treas. Reg. section 1.162-3, except 1.162-3(e))
- Acquisition and production of tangible property
  - deducting amounts paid or incurred in the process of investigating or otherwise pursuing the acquisition of real property (Treas. Reg. section 1.263(a)-2(f)(2)(iii))
  - capitalization of inherently facilitative amounts allocable to real or personal property (Treas. Reg. section 1.263(a)-2(f)(3)(ii))
- Change to the optional regulatory accounting method (Treas. Reg. section 1.263(a)-3(m))

## *Section 481(a) adjustment (other considerations)*

Use of statistical sampling is permitted by following the guidance provided in Rev. Proc. 2011-42

- Exception - change in method that requires a modified Section 481(a) adjustment.

### Effect of UNICAP

- Rules generally require that the Section 481(a) adjustment show the effect of Section 263A on items that are included in the method change
  - Consider - if not in compliance with UNICAP for the items being changed under the final regulations, there would be no collateral effect of UNICAP in the Section 481(a) adjustment
  - Examination has discretion to review the Section 481(a) adjustment

## *Form 3115, Part IV – Section 481(a) adjustments for multiple changes*

Generally separate Section 481(a) adjustments and spread periods

Netting permitted for changes under DCN 7, 184, 199, 200, 205, 206, 207

## *Filing procedures*

Dual filing requirement:

- File Form 3115 copy with IRS in Covington, KY no later than the date the federal income tax return is filed for the year of change (including extensions)
- Attach Form 3115 to the federal income tax return for the year of change

*Implementation of change in  
accounting method regs and  
Rev. Proc. 2015-20 relief  
from Form 3115  
requirements*

## *Rev. Proc. 2015-20*

- Issued February 2015
- Applies to a small business taxpayer
  - Defined as a business with total assets of less than \$10 million or,
  - A business with average annual gross receipts of \$10 million or less for the prior three taxable years
- Provides a small business taxpayer a simplified adoption process for the Tangible Property Regulations

## *Simplified adoption process*

- First taxable year that begins on or after January 1, 2014
  - Small business taxpayers able to make certain tangible property changes without filing a Form 3115
- Ongoing
  - Small business taxpayers have the option to make tangible property regulation changes with a limited Section 481(a) adjustment

## *Changes covered by Rev. Proc. 2015-20 (tangible property changes)*

- Change to deducting amounts paid or incurred for repairs and maintenance or vice versa - includes change in the method of identifying the unit of property
- Change to the regulatory accounting method
- Change to deducting non-incidentals materials and supplies when used or consumed
- Change to deducting incidental materials and supplies when paid or incurred
- Change to deducting non-incidentals rotatable and temporary spare parts when disposed of
- Change to the option method for rotatable and temporary spare parts
- Change by a dealer in property to deduct commissions and other costs that facilitate the sale of property
- Change by a non-dealer in property to capitalizing commissions and other costs that facilitate the sale of property
- Change to capitalizing acquisition or production costs and, if depreciable to depreciating such property under section 167 or section 168
- Change to deducting certain costs for investigating or pursuing the acquisition of real property

## *Changes covered by Rev. Proc. 2015-20 (disposition related changes)*

- Change in the method of identifying which assets in multiple asset accounts or which portions of assets have been disposed of from the FIFO method of accounting or the modified FIFO method of accounting to the specific identification method
- Change in the method of identifying which assets in multiple asset accounts or which portions or assets have been disposed of from the FIFO method of accounting to the modified FIFO method of accounting or vice versa
- Change in the method of identifying which mass assets in multiple asset accounts or which portions of mass assets have been disposed of by the taxpayer from the FIFO method of accounting or the modified FIFO method to a mortality dispersion table
- Change in the method of identifying which mass assets in multiple asset accounts or which portions of mass assets have been disposed of from a mortality dispersion table to the specific identification method, the FIFO method of accounting, or the modified FIFO method of accounting
- Disposition of a building or structural component
- Disposition of tangible depreciable assets (other than a building or its structural components)

## *Benefits of revenue procedure*

- Provides taxpayers a simplified adoption process
- Administrative convenience (i.e., less time spent gathering and analyzing data)
- First year beginning on or after January 1, 2014 - no requirement to file Form 3115

## *Potential pitfalls in utilizing Rev. Proc. 2015-20*

- Taxpayer must choose to make a Section 481(a) adjustment that does not take into account amounts paid or incurred in taxable years beginning before January 1, 2014 for any change made under section 10.11 of Rev. Proc. 2015-14
- Also limited on certain disposition changes
- Due to limited Section 481(a) adjustment, taxpayer only receives audit protection for amounts paid or incurred in taxable years beginning on or after January 1, 2014
- 2014 tax year implementation - taxpayer precluded from making late partial disposition election

## *Implementation of the regulations*

- First initial year (Adoption of the tangible property regulations)
  - Review of the regulations
  - Adoption of the regulations
  - Historical conformity to the regulations (Section 481(a) adjustment)
- Subsequent years
  - Educate taxpayers on improvement standards and how to interpret and apply
  - Review, revise, and assist clients with capitalization policies
  - Review and assist clients with system changes necessary to maintain conformity with the regulations

## *Other considerations and annual elections*

- Safe harbor for routine maintenance
- De minimis safe harbor election
- Election to capitalize repair and maintenance costs (book conformity)
- Small taxpayer safe harbor
- Partial disposition election

## *Safe harbor for routine maintenance*

- Amounts paid for routine maintenance are not deemed to improve that unit of property
- Routine maintenance for buildings
  - Recurring activities a taxpayer expects to perform to keep the building structure or each building system in its ordinarily efficient operating condition
    - Inspection, cleaning, and testing of building structure or each building system
    - Replacement of worn parts with comparable and commercially available parts
  - Activities are routine if the taxpayer reasonably expects to perform the activities more than once during the 10-year period beginning at the time the building structure or the building system is placed in service

## *Safe harbor for routine maintenance (continued)*

- Routine maintenance for property other than buildings
  - Recurring activities the taxpayer reasonably expects to perform to keep the property in its ordinarily efficient operating condition
    - Inspection, cleaning, and testing of the unit of property
    - Replacement of damaged or worn parts with comparable and commercially available replacement parts
  - Activities are routine if the taxpayer expects to perform the activities more than once during the unit of property's class life

## *Safe harbor for routine maintenance (continued)*

- Selected Exceptions
  - Amounts paid for a betterment to a unit of property
  - Amounts paid for the replacement of a component of a unit of property for which a loss has been deducted for that component
  - Amounts paid to return a unit of property to its ordinarily efficient operating condition, if the property has fallen into a state of disrepair and is no longer functional for its intended use
  - Amounts paid to adapt a unit of property to a new and different use

## *De minimis safe harbor election*

- Annual election - election statement required with tax return
- Two categorizations of taxpayer
  - AFS
  - Non-AFS
- AFS and Non-AFS
  - Amounts paid for property costing less than a specified dollar amount
  - Amounts paid for property with an economic useful life or 12 months or less
  - Taxpayer treats the amount paid as an expense on its financial statements or books and records (dependent on which is applicable)
  - The amount paid does not exceed \$5,000 (AFS) or \$2,500 (Non-AFS) per invoice (or per item as substantiated by the invoice)
- AFS
  - Taxpayer has written accounting procedures in place treating as expense

## *De minimis safe harbor election (continued)*

- Exceptions
  - Amounts paid for inventory property
  - Amounts paid for land
  - Amounts paid for rotatable, temporary, and standby emergency spare parts that the taxpayer elects to capitalize and depreciate
  - Amounts paid for rotatable and temporary spare parts that the taxpayer accounts for under the optional method of accounting for rotatable parts

## *Election to capitalize repair and maintenance costs*

- Annual election - election statement required with tax return
- Amounts paid for repair and maintenance to tangible property must be capitalized on taxpayer's books and records
- Amounts must be incurred in carrying on the taxpayer's trade or business
- Note: Repairs and maintenance  $\neq$  materials and supplies

## *Safe harbor for small taxpayers*

- Annual election for qualified small taxpayers
  - Average annual gross receipts for the three preceding taxable years is less than or equal to \$10 million
- Allows qualifying taxpayer to elect to not treat amounts paid as improvements to eligible building property if the total amount paid during the taxable year for repairs, maintenance, and similar activities performed on the eligible building property does not exceed the lesser of
  - 2 percent of the unadjusted basis of the eligible building property
  - \$10,000

## *Safe harbor for small taxpayers (continued)*

- Amounts paid for repairs, maintenance, improvements, and similar activities include amounts expensed under de minimis safe harbor and amounts treated as routine maintenance under the safe harbor

## *Partial disposition election*

- Election made to dispose of a portion of an asset
- Taxpayer disposes of part of an asset and reports the gain, loss, or other deduction on timely filed return

*Final thoughts & questions*