

## Chapter 5: Capitalization vs. Repair Update

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**Please note.** Corrections were made to this workbook through January of 2016. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as shortURLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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### LEGISLATIVE BACKGROUND

Treasury Decision (TD) 9636<sup>1</sup> — commonly referred to as the new tangible property regulations — was issued on September 13, 2013. It is the most recent effort by the IRS to provide clear and final guidance about the deduction and capitalization of expenditures related to tangible property. This attempt to combine decades of case law, administrative rulings, and other authoritative statements resulted in a massive overhaul of the tax rules in this area.

The basic issue addressed by the regulations is the same issue that has always been present for taxpayers — finding the line between a currently deductible expense under IRC §162(a) and those expenses that cannot be currently deducted but must be capitalized under IRC §263(a). IRC §162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on the taxpayer's trade or business, including amounts paid for incidental repairs. IRC §263(a) denies a deduction for any amount paid for new property or any permanent improvements or betterments that increase value of any property, or amounts spent to restore property.

Although the resulting new regulations clarified some issues, as intended, they also created substantial confusion, concern, and uncertainty about other issues.

In 2015, the IRS issued several revenue procedures<sup>2</sup> to guide taxpayers on making a change in their accounting method for tax purposes. One of these revenue procedures was issued to simplify the process for small business taxpayers to adopt new accounting procedures under the regulations.

<sup>1</sup>. TD 9636, 2013-43 IRB 331.

<sup>2</sup>. Rev. Proc. 2015-13, 2015-5 IRB 419; Rev. Proc. 2015-14, 2015-5 IRB 450; Rev. Proc. 2015-20, 2015-9 IRB 694.

## UNIT OF PROPERTY

**Unit of property** refers to the base of property that is used to determine whether an improvement exists. In general, the larger the unit of property, the more likely that expenses associated with it will not be viewed as a capitalized improvement. All components of property that are functionally interdependent comprise a single unit of property. **Functionally interdependent** means that the placing in service of one component is dependent on the placing in service of another component.

1. **Buildings.** An entire building structure (roof, walls, windows, floors and ceiling) is one unit of property. Each building system is a separate unit of property. The regulations identify eight separate building systems that are considered separate units of property from the building structure. This means that when replacing components of one of these systems, it will be more difficult to treat it as a repair expense. The eight separate building systems are as follows:
  - ♦ Plumbing system
  - ♦ Electrical system
  - ♦ Heating, ventilating, and cooling (HVAC) system
  - ♦ Elevator system
  - ♦ Escalator system
  - ♦ Fire protection and alarm system
  - ♦ Gas distribution system
  - ♦ Security system

**Note.** A lessee of a portion of a building applies this rule to the portion of the building they lease. A lessor of an entire building applies the improvement rules to the entire building structure and each key building system owned.

2. **Nonbuildings.** The unit of property includes all components that are **functionally interdependent**. Components of property are functionally interdependent if one component of property cannot be placed into service without also placing into service another component of property.
3. **Plant property.** The unit of property includes each component or group of components within the plant that performs a **discrete and major function or operation**. Examples of plant property include manufacturing plants and generation plants.
4. **Network assets.** Generally, network assets include assets that form an interconnected grid or web system. Pipelines, railroad tracks, water and sewage lines, power transmission lines, and cable lines are included in this category.<sup>3</sup> The particular facts and circumstances or industry guidance from the Treasury Department and the IRS determines the unit of property and the application of the improvement analysis.

**Note.** For further details about the definitions of the four categories of property and the application of the unit of property concept to each category, see Treas. Reg. §1.263(a)-3(e). Also see the 2014 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Capitalization or Repair.

<sup>3</sup>. Treas. Reg. §1.263(a)-3(e).

## MATERIALS AND SUPPLIES<sup>4</sup>

Taxpayers that have materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operations during the tax year for which the return is made. This applies if the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year.<sup>5</sup>

Incidental materials and supplies may be deducted when purchased. Materials and supplies are incidental if no record of consumption is kept or physical inventories at the beginning and end of the tax year are not taken.<sup>6</sup> Nonincidental materials and supplies are deductible in the tax year in which the materials and supplies are first used or consumed in the taxpayer's operations.<sup>7</sup>

### APPLICATION TO FARMERS

A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming.<sup>8</sup> The tangible property regulations in TD 9636 did not change or affect this rule. Thus, it remains available to all farmers. The deduction for materials and supplies is based on the amounts expended, not amounts consumed.

**Observation.** Treas. Reg. §1.162-12(a) specifically applies to farmers. It is an exception from the more general provisions of Treas. Reg. §1.162-3(a), which otherwise defers the deductibility of nonincidental materials and supplies until the year consumed. It is for this reason that cash method farmers may report their financial position and results of operations using GAAP-based financial statements without being required to defer tax deductions for prepaid expenses if the expenses are deferred on the financial statement.

### TIRES

#### Non-Agricultural Tires

For non-agricultural trucks and tractors, the IRS has provided a safe harbor method of accounting for the cost of original and replacement tires for qualifying vehicles.<sup>9</sup> The tangible property regulations did not change the safe harbor. Under the safe harbor, a qualifying vehicle's tires are treated as part of the vehicle and not as separate assets. A qualifying vehicle is one for which depreciation is determined under IRC §168 and includes converter dollies and vehicles described in asset class 00.241 (light general purpose trucks), 00.242 (heavy general purpose trucks), 00.26 (tractor units for over-the-road use) and 00.27 (trailers and trailer-mounted containers) of Rev. Proc. 87-56.<sup>10</sup>

<sup>4</sup> Special acknowledgement is given to Chris Hesse, principal with CliftonLarsonAllen, CPAs, Minneapolis, MN, for assistance with authorship, comment, and review of this section.

<sup>5</sup> Treas. Reg. §1.162-3, as reflected before TD 9636, 2013-43, IRB 331, generally effective for tax years beginning after 2013.

<sup>6</sup> Treas. Reg. §1.162-3(a)(2).

<sup>7</sup> Treas. Reg. §1.162-3(a)(1).

<sup>8</sup> Treas. Reg. §1.162-12(a).

<sup>9</sup> Rev. Proc. 2002-27, 2002-1 CB 802.

<sup>10</sup> Rev. Proc. 87-56, 1987-2 CB 674.

Under the safe harbor, the taxpayer must capitalize the cost of the original tires of a qualifying vehicle and depreciate them under IRC §168 using the same depreciation method, recovery period, and convention applicable to the vehicle on which the tires are first installed. The taxpayer must also treat the original tires of the qualifying vehicle as being disposed of at when the taxpayer disposes of the vehicle on which the tires were first installed. In addition, the taxpayer must deduct the cost of the replacement tires of the qualifying vehicle as an expense in the tax year the replacement tires are installed on the vehicle by the taxpayer.

**Example 1.** Tom placed a light truck in service in 2010 and replaced the tires in 2012 and 2014. Under the safe harbor, the taxpayer depreciates the original tires as part of the truck over the truck's 5-year MACRS recovery period (even though they are replaced in 2012) but can expense the cost of the replacement tires in 2012 and 2014.

**Observation.** It may not be a good strategy to elect the safe harbor if the taxpayer has tires that normally wear out within a year. By not electing the safe harbor, the taxpayer can expense their original tires and replacement tires if they normally wear out within one year. If the election is made, the cost of the original tires can only be recovered via depreciation as part of the vehicle cost.

## Agricultural Tires

Rev. Proc. 2002-27 applies to "qualifying vehicles," which includes those in asset classes 00.241, 00.242, 00.26 and 00.27. As mentioned previously, these are light general purpose trucks (i.e., pickups), heavy general purpose trucks, truck tractors and truck trailers. These asset classes do not include farm tractors.

**Example 2.** Ralph bought a tractor in 2012 and depreciated the tractor's cost (including the tires) over seven years using the 150% declining balance method for farm equipment. In 2015, Ralph paid \$20,000 to replace all of the tires on his tractor. Because Ralph's tractor is property other than a building, the initial unit of property for the tractor is determined under the general rule in Treas. Reg. §1.263(a)-3(e)(3)(i). It is composed of all the components that are functionally interdependent. Under this rule, Ralph must treat the tractor, including its tires, as a single unit of property because the tractor and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the tractor).<sup>11</sup> Because the replacement tires do not improve the tractor (they do not adapt the tractor to a new or different use, are not a betterment, and are not a restoration), Ralph can deduct the cost of the tires as a business expense under IRC §162 on his 2015 income tax return.

Further bolstering the point that farm tires are not treated as separate components of a unit of property, Treas. Reg. §1.263(a)-3(e)(5) states:

*Notwithstanding the unit of property determination under paragraph (e)(3) of this section, a component (or a group of components) of a unit property must be treated as a separate unit of property if, at the time the unit of property is initially placed in service by the taxpayer, the taxpayer has properly treated the component as being within a different class of property under section 168(e) (MACRS classes) than the class of the unit of property of which the component is a part, or the taxpayer has properly depreciated the component using a different depreciation method than the depreciation method of the unit of property of which the component is a part. [Emphasis added.]*

The key word of that regulation is "if." The concept of the regulation does not apply in agriculture to farm tractor (or combine, etc.) tires. Farm tractor tires do not wear out in one year, and the easier approach is to treat them as part of the asset's cost. Because they are not depreciated separately, the component rule of the regulation does not apply.

<sup>11</sup> Treas. Reg. §1.263(a)-3(e)(6), Example 16.

## Summary

The standard still holds that if the asset wears out (because truck tires are viewed as separate assets) within 12 months, they are expensed. This standard is beneficial to the trucking industry because it allows the benefit of separately handling tires. In addition, only over-the-road trucks and trailers are eligible equipment for purposes of the safe harbor of Rev. Proc. 2002-27. Rev. Proc. 2002-27 does not apply to all tires used in any business; it does not apply to farm tractor tires.

Tractor tires are always deductible when they are purchased to replace tires on an existing tractor. They are not separately identified and depreciated but instead are part of the unit of property — the tractor. They are treated as repairs when replaced. However, they are not deductible when a taxpayer buys a tractor. Although heavy trucks are also used in agriculture, such trucks are commonly depreciated as a unit (including their tires). Agricultural heavy truck tires are not separately treated as a 7-year farm equipment asset.

## TANGIBLE PROPERTY REGULATIONS REVIEW

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**Note.** For comprehensive coverage of the tangible property regulations, see the 2014 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Capitalization or Repair.

The new tangible property regulations are generally effective for tax years beginning on or after January 1, 2014. The following aspects of these regulations are explained in this section.

- De minimis safe harbor for materials and supplies
- Methods of distinguishing between repairs and improvements for tax purposes
- The partial disposition election

**Note.** The IRS provides a concise overview of these regulations that practitioners may find useful as a reference. This can be found at [uofi.tax/15a7x9](http://uofi.tax/15a7x9) [[www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection](http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection)].

## DE MINIMIS SAFE HARBOR<sup>12</sup>

Under the tangible property regulations, a taxpayer may elect to apply a **de minimis safe harbor** to amounts **paid to acquire or produce tangible property, including materials and supplies**. This safe harbor allows the taxpayer to deduct small-dollar expenditures without analyzing each purchase to determine if it should be capitalized.

### Materials and Supplies

	Election	Who May Elect
Parts used in repairs and maintenance	None	
Useful life of (or consumed in) less than 12 months	None	
Individual items costing less than \$200	None	
Individual items costing less than \$500	Annual de minimis safe harbor election	All taxpayers
Individual items costing less than \$5,000	Annual de minimis safe harbor election	Only taxpayers issuing applicable financial statements (AFS)

<sup>12</sup> *Tangible Property Regulations — Frequently Asked Questions*. Mar. 13, 2015. Internal Revenue Service. [[www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection](http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection)] Accessed on Jun. 9, 2015.

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The choice to use the de minimis safe harbor is an **annual election** that does not constitute a change in accounting method. Therefore, filing Form 3115, *Application for Change in Accounting Method*, is not required when the taxpayer decides to use (or not use) the de minimis safe harbor for any tax year. (Form 3115 is discussed later.)

Generally, the new tangible property regulations do **not** change the rules for deducting materials and supplies. The general rules define materials and supplies as tangible, noninventory property used and consumed in the taxpayer's operations. These regulations indicate that costs relating to property in any of the following categories qualify as materials or supplies.

Category	Description of Costs
Acquired components	Costs of components acquired to maintain, repair, or improve tangible property owned, leased, or serviced by the taxpayer that are not acquired as part of a larger item of tangible property
Consumables	Costs of fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in operations
12-month property	Costs of tangible property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in operations
\$200 property	Costs of tangible property that has an acquisition cost or production cost of \$200 or less (For tax years beginning before January 1, 2014, this limit was \$100. <sup>13</sup> )

In simple terms, the de minimis safe harbor election is an administrative convenience that permits taxpayers to elect to deduct small-dollar expenditures that otherwise must be capitalized under the general rules. Under the final regulations, a taxpayer may elect to apply the de minimis safe harbor to these expenditures if they qualify. The qualifications depend on whether the taxpayer has an applicable financial statement (AFS), which is defined later in this section. The following table summarizes these qualifications for taxpayers with and without an AFS.

AFS Taxpayers <sup>14</sup>	Non-AFS Taxpayers <sup>15</sup>
The taxpayer must have <b>written</b> accounting procedures at the beginning of the tax year that, for nontax purposes, treat as an expense: <ul style="list-style-type: none"> <li>• Amounts costing less than a specified amount, or</li> <li>• Amounts paid for property with an economic useful life of 12 months or less.</li> </ul>	The taxpayer must have accounting procedures at the beginning of the tax year that, for nontax purposes, treat as an expense: <ul style="list-style-type: none"> <li>• Amounts costing less than a specified amount, or</li> <li>• Amounts paid for property with an economic useful life of 12 months or less.</li> </ul>
The AFS must reflect the deduction of costs as outlined in the <b>written</b> accounting procedures.	Books and records must reflect the deduction of costs as outlined in the accounting procedures.
The amounts of the items expensed under the written accounting policy do not exceed <b>\$5,000</b> per invoice (or per item as substantiated by an invoice).	The amounts of the items expensed under the accounting policy do not exceed <b>\$500</b> per invoice (or per item as substantiated by an invoice).

<sup>13</sup>. See TD 9636, 2013-43 IRB 331 and TD 9564, 2012-14 IRB 614.

<sup>14</sup>. Treas. Reg. §1.263(a)-1(f)(1)(i).

<sup>15</sup>. Treas. Reg. §1.263(a)-1(f)(1)(ii).

**Note.** The necessary accounting procedures for **non-AFS** taxpayers **do not need to be written**. However, to deduct the costs of materials and supplies under this safe harbor, treating the costs as current expenses must be part of a consistent accounting policy or procedure that exists at the beginning of the tax year.<sup>16</sup> Even if an expenditure meets the conditions to be expensed under these rules, the cost might be subject to capitalization under the IRC §263A uniform capitalization rules.<sup>17</sup>

The \$5,000 and \$500 threshold amounts **are not intended as ceilings on the amounts that can be deducted as ordinary business expenses**. The use of the de minimis election does not mean that the taxpayer must capitalize all expenses over the applicable threshold amount.

**Observation.** For many small business taxpayers, the higher IRC §179 limits have been used as a way to deduct small-dollar expenditures without analyzing each purchase individually. The option to elect the §179 deduction on an amended return has also been used as a form of audit protection. If an IRS examiner found an item in expenses that should have been capitalized, the taxpayer could elect the IRC §179 deduction at that time. Absent legislative action, the option to use the §179 deduction on an amended return expired for tax years beginning after December 31, 2014.<sup>18</sup>

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For costs that do **not** qualify under the de minimis safe harbor, taxpayers must apply the general rules for identifying and deducting repair and maintenance costs, incidental supplies, and nonincidental materials and supplies. The de minimis safe harbor does **not** apply to the following.

1. Amounts paid for property that is or is intended to be included in inventory property
2. Amounts paid for land
3. Amounts paid for rotatable, temporary, and standby emergency spare parts that the taxpayer elects to capitalize and depreciate under Treas. Reg. §1.162-3(d)
4. Amounts paid for rotatable and temporary spare parts that the taxpayer accounts for under the optional method of accounting for rotatable parts pursuant to Treas. Reg. §1.162-3(e)

**Note.** In Rev. Proc. 2015-20, the IRS requested written comments by April 21, 2015, on whether it is appropriate to increase the de minimis safe harbor limit for a taxpayer without an AFS to an amount greater than \$500. As of this workbook's date of publication, the IRS had not increased this amount.

<sup>16</sup> *Tangible Property Regulations — Frequently Asked Questions*. Mar. 13, 2015. Internal Revenue Service. [[www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection](http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection)] Accessed on Jun. 9, 2015.

<sup>17</sup> Treas. Reg. §1.263(a)-1(f)(1).

<sup>18</sup> IRC §179(c)(2).



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## Applicable Financial Statements<sup>19</sup>

AFSs fall into three categories. The order of priority (from highest to lowest), is as follows.

1. A statement that is required to be filed with the Securities and Exchange Commission (SEC) (Form 10-K or the Annual Statement to Shareholders)
2. A certified **audited** financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for one of the following:
  - Credit purposes
  - Reporting to shareholders, partners, or similar persons
  - Any other substantial nontax purpose
3. A financial statement (other than an income tax return) that is required to be provided to the federal government, a state government, or any federal or state agency (**other** than the SEC or the IRS).

**Note.** Under these regulations, **acceptance** of (and reliance on) the taxpayer's financial statement by an outside party or agency (such as a bank or government agency) is a **necessary** element of a valid AFS.

**Observation.** The preceding regulatory definition of AFS appears to leave many issues unresolved about what type of information may qualify as an AFS. This is particularly true for businesses using unaudited financial information as a basis for meeting the AFS requirement. It is an open question whether an unaudited statement provided to a bank (instead of directly to a federal or state government or agency) in connection with a government-insured loan meets the definition of AFS, when it is not required by the federal or state government or agency. In addition, the regulation does not directly define "financial statement." Moreover, the federal or state government may require a financial statement to be furnished to the bank only for the first year of the loan but not for subsequent years. The regulation does not directly address this situation. Further IRS guidance or judicial development of this regulation is necessary to clarify "gray areas" inherent in this regulation as currently drafted.

## Electing the De Minimis Safe Harbor

To use the safe harbor, the taxpayer should attach a statement titled "Section 1.263(a)-1(f) De Minimis Safe Harbor Election" to the **timely filed original federal tax return** (including extensions) for the tax year in which the de minimis amounts are paid or accrued. The statement should include the taxpayer's name, address, and taxpayer identification number (TIN), as well as a declarative statement that the taxpayer is making the de minimis safe harbor election.

**Example 3.** Bob Gold operates a pawn shop as a sole proprietorship. In 2015, he purchases a printer for \$350. Bob does not have an AFS.

The printer does not meet the definition of a material or supply under the general rules. Therefore, Bob must capitalize and depreciate the printer unless he makes the de minimis safe harbor election for 2015. Bob attaches the following statement to his 2015 return.

Bob Gold	TIN: 123-45-5678
Address: 66 Main St., Storybrooke, ME 04410	
Section 1.263(a)-1(f) De Minimis Safe Harbor Election	
The taxpayer elects to make the de minimis safe harbor election under Regulation 1.263(a)-1(f).	

<sup>19</sup> Treas. Reg. §1.263(a)-1(f)(4).



**Note.** In **Example 3**, if Bob purchased 20 printers for \$350 each (\$7,000 in total), electing the de minimis safe harbor requires the expensing of each printer.

**Example 4.** Emma Swan owns a detective agency, which she operates as a sole proprietorship. In 2015, she acquires a new laptop computer for \$2,500. Because her company does not have an AFS, the de minimis safe harbor election does not apply to purchases of \$500 or more. Emma is not allowed to expense the computer as a material or supply in 2015.

**Note.** Even though Emma may not use the de minimis safe harbor election to expense the laptop, she may be able to expense the laptop under IRC §179 if all other requirements are met. For more information about the requirements for IRC §179, see the 2015 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Depreciation.

The safe harbor is not intended to prevent taxpayers from reaching an agreement with IRS examiners to use a larger amount. In any event, it may be prudent to elect the \$500 amount even if a larger amount is used. Amounts deducted under the de minimis rule are not capitalized and are not treated as a material or supply. Instead, they are treated as “small equipment” and are tracked separately on the taxpayer’s books and records.

## DISTINGUISHING BETWEEN REPAIRS AND IMPROVEMENTS<sup>20</sup>

The tangible property regulations create a regulatory facts and circumstances framework for analyzing whether expenditures are **deductible repairs** or **capital improvements**. The regulations also establish three alternatives to the facts and circumstances test: a safe harbor election related to buildings for small taxpayers, a safe harbor for routine maintenance, and an election to capitalize repair and maintenance costs.

### Facts and Circumstances Test

A taxpayer may always use the facts and circumstances test to determine if expenditures may be deducted in the current year as a repair and maintenance expense or if they must be capitalized as an improvement. The key to this test is the definition of the term **unit of property**. After the unit of property is identified, the facts and circumstances are analyzed to determine whether an **improvement** was made to the unit of property.

**Improvements.** Once the unit of property is identified, the next step in the facts and circumstances test is to determine whether the expenditure resulted in an improvement to the property. An improvement is defined as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or real estate. It also includes any amount paid for restoring property or making good the exhaustion of it for which an allowance is or has been made.<sup>21</sup> If the property was improved, the expenditure must be capitalized. The regulations identify three types of improvements that must be capitalized.

1. Betterments<sup>22</sup>
2. Restorations<sup>23</sup>
3. Adaptations that result in a new or different use<sup>24</sup>

<sup>20</sup> *Tangible Property Regulations — Frequently Asked Questions*. Mar. 13, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection] Accessed on Jun. 9, 2015.

<sup>21</sup> Treas. Reg. §1.263(a)-1(a).

<sup>22</sup> Treas. Reg. §1.263(a)-3(j).

<sup>23</sup> Treas. Reg. §1.263(a)-3(k).

<sup>24</sup> Treas. Reg. §1.263(a)-3(l).

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**Betterments.** A **betterment** includes any of the following.

- An amount paid to **fix a material condition or material defect** in the property that existed before the property was acquired or that arose during production of the unit of property
- An amount paid for a **material addition**, including a physical enlargement, expansion, extension, or addition of a major component of the property (This also includes an expenditure to materially increase the property's capacity, such as the cost to increase the unit of property's cubic or linear space.)
- An amount paid that is reasonably expected to materially increase productivity, efficiency, strength, quality, or output of the unit of property, where applicable

To determine whether an expenditure is for a betterment, the regulations require the taxpayer to compare the condition of the property immediately after the expenditure with the property's condition immediately before the circumstance necessitating the expenditure.<sup>25</sup> Other factors that should be considered to determine whether a betterment exists include the following:

- Remediation costs that are used to correct a material condition or defect in existence before the taxpayer's purchase are a betterment.<sup>26</sup>
- Upgrading a unit of property due to the unavailability of the same size replacement part is not a betterment.<sup>27</sup>
- An amount incurred to satisfy a regulatory requirement is not treated as a betterment.<sup>28</sup>

**Restorations.** The following list summarizes the types of expenditures that fall under the definition of a restoration of property.

- The cost to replace a major component or substantial structural part (This includes any amount paid for the replacement of a part or combination of parts that make up a major component. The cost of replacing a substantial structural part of the unit of property is also included.)
- An expense incurred to return the unit of property to its ordinarily efficient operating condition, if the unit of property has deteriorated to a state of disrepair and is no longer functional for its intended use
- An amount paid for rebuilding the unit of property to a like-new condition after the end of its class life

**Adaptations.** An **adaptation** changes how the property can be used in a way that is not consistent with the taxpayer's ordinary use of the unit of property when it was originally placed in service. An adaptation must be capitalized if the amount paid to adapt a unit of property to a new or different use is not consistent with the taxpayer's ordinary use of the unit of property at the time the taxpayer placed the property in service.

**Note.** For examples of costs associated with betterments, restorations, and adaptations, see the 2014 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Capitalization or Repair. Numerous examples can also be found in Treas. Reg. §1.263(a)-3.

<sup>25</sup> Treas. Reg. §1.263(a)-3(j)(2)(iv).

<sup>26</sup> Treas. Reg. §1.263(a)-3(j)(3), example 1.

<sup>27</sup> Treas. Reg. §1.263(a)-3(j)(2)(iii).

<sup>28</sup> Treas. Reg. §1.263(a)-3(j)(3), example 12.

## Alternatives to the Facts and Circumstances Analysis

Instead of analyzing each expenditure using the facts and circumstances tests to determine if the cost must be capitalized or may be expensed, the tangible property regulations allow the following alternatives.

1. The safe harbor election (regarding buildings) for small taxpayers
2. The safe harbor for routine maintenance
3. The election to capitalize repair and maintenance costs

**Safe Harbor Election (for Buildings) for Small Taxpayers.**<sup>29</sup> Certain taxpayers may elect to expense the cost of work performed on a building without analyzing the expenditure to determine if it was an improvement. The election is available to taxpayers who meet **both** of the following conditions.

1. The taxpayer's average annual gross receipts are \$10 million or less for the three preceding tax years.

**Note.** If the taxpayer has been in existence for less than three tax years, the taxpayer determines its average annual gross receipts for the number of tax years (including short years) that the taxpayer (or its predecessor) has been in existence.<sup>30</sup>

2. The **unadjusted basis** of the building property owned or leased by the taxpayer is \$1 million or less.

**Note.** For information about determining the annualized gross receipts for a short tax year, see Treas. Reg. §1.263(a)-3(h)(3)(iii).

The unadjusted basis of property owned is generally determined as it is for other tax purposes. For a leased building, the unadjusted basis of the property leased to the taxpayer is the **total amount of undiscounted rent paid and expected to be paid for the entire lease term**. This includes rents due for all renewal periods if all the facts and circumstances present at the lease's inception indicate a reasonable expectancy of renewal.<sup>31</sup>

**Note.** For further details regarding the qualifications for this election, see Treas. Reg. §1.263(a)-3(h) and the 2014 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Capitalization or Repair.

The election may be made only when the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities performed on the building property does not exceed the **lesser of**:

1. 2% of the **unadjusted** basis of the eligible building property, or
2. \$10,000.

<sup>29</sup> Treas. Reg. §1.263(a)-3(h); *Tangible Property Regulations — Frequently Asked Questions*. Mar. 13, 2015. Internal Revenue Service. [[www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection](http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection)] Accessed on Jun. 9, 2015.

<sup>30</sup> Treas. Reg. Sec. 1.263-3(h)(3)(ii).

<sup>31</sup> Treas. Reg. §1.263(a)-3(h)(5)(ii). For significant factors indicating whether a reasonable expectancy of lease renewal exists, see Treas. Reg. §1.263(a)-4(f)(5)(ii).

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The taxpayer must elect to use the safe harbor **each** tax year in which a qualifying amount is incurred. The election is made by attaching a statement to the original, timely filed (including extensions) income tax return for each tax year that a qualifying amount was paid or incurred. The statement must be titled “Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers.” The statement must include:

1. The taxpayer’s name, address, and TIN; and
2. A description of each eligible building property to which the taxpayer is applying the election.

**Example 5.** Touchstone Inc. is a custom glassworks manufacturer that is taxed as a C corporation. Its 3-year average annual receipts are under \$10 million. The company rents the building it uses for its operations. The lease term is 20 years, including expected renewals, and the monthly lease amount is \$2,000. The unadjusted basis of the leased building is \$480,000 ( $\$2,000 \times 20 \text{ years} \times 12 \text{ months}$ ). Touchstone meets the qualifications of a small taxpayer for purposes of the safe harbor election.

In 2015, Touchstone pays \$4,000 for repairs and improvements to the building. This is less than 2% of the unadjusted basis of the building ( $\$480,000 \times 2\% = \$9,600$ ). (Because the 2% test results in an amount less than \$10,000, the 2% test is used.)

Touchstone attaches the following statement to its 2015 tax return to elect to expense all the repairs and improvements on the building.

Touchstone, Inc.

TIN: 123-45-7004

Address: 238 Blythe Court, Seattle, WA 98122

## Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers

The taxpayer elects to make the safe harbor election under Regulation 1.263(a)-3(h) for the leased property located at 238 Blythe Court in Seattle, Washington.

**Safe Harbor for Routine Maintenance.**<sup>32</sup> The taxpayer is **not** required to capitalize expenditures for recurring maintenance necessary to keep a unit of property in an ordinarily efficient operating condition. To be considered **routine**, the taxpayer must reasonably expect that the maintenance expense will be needed more than once during the following periods.

1. For **building structures** and **building systems**, more than once during the **10-year period** beginning when placed in service
2. For property other than buildings, more than once **during the class life** of the unit of property

**Note.** Even if the expenditure does not meet the requirements for the routine maintenance safe harbor, the taxpayer may still deduct it if the expenditure is not deemed an improvement under the facts and circumstances analysis discussed earlier.

The routine maintenance safe harbor does not apply to amounts paid for betterments. However, it does apply to certain restorations that would otherwise be improvements, such as replacing a major component or substantial structural part of a unit of property.

<sup>32</sup> Treas. Reg. §1.263(a)-3(i).

**Example 6.** Marshall purchased a commercial building in 2000. He knew at the time that he would need to replace the carpets approximately every three years. Carpeting has a class life of 10 years. Replacing the carpeting qualifies under the routine maintenance safe harbor because he plans on doing so at least three times during each 10-year period.

In 2015, Marshall spends \$57,000 to replace all the carpeting in the building. Marshall may deduct the cost of the replacement in 2015 under the safe harbor for routine maintenance. If this safe harbor is not used, the cost of replacing the carpet is still deductible because the unit of property is the building structure, and the cost of the carpet is not material to the cost of the structure.

The safe harbor for routine maintenance is **not an election**. The IRS intended the regulations to be based on prior law.<sup>33</sup> A taxpayer who was in compliance with the previous regulations is not required to take any action to be protected by this safe harbor. However, a taxpayer who was not in compliance or who wants to change their accounting method to use this safe harbor should file Form 3115. The application of the safe harbor will usually arise in situations in which the taxpayer is changing to the routine maintenance safe harbor or is already applying it in the normal course of business.

**Caution.** Although the IRS did not intend for Treas. Reg. §1.263(a)-3 to create new law, the unit of property concept and the division of buildings into specific structural components were not part of the previous regulatory structure. For this reason, some experts advise the taxpayer to file Form 3115 to adopt these concepts as part of their accounting method.

**Election to Capitalize Repair and Maintenance Costs.**<sup>34</sup> The final regulations include an election to capitalize repair and maintenance expenses as improvements if the taxpayer treats such costs as capital expenditures for financial accounting purposes. If the election is made, it applies to **all** repairs capitalized on the taxpayer's books and records during the tax year.

The election to capitalize repair and maintenance expenses is made annually. The election is made by attaching a statement to the taxpayer's timely filed original federal tax return (including extensions) for the tax year in which the amounts were paid. The statement must be titled "Section 1.263(a)-3(n) Election." It must include the taxpayer's name, address, and TIN, as well as a declaration that the taxpayer is making the election to capitalize repair and maintenance costs under §1.263(a)-3(n).

Making an annual election does not change the taxpayer's accounting method. Therefore, filing Form 3115 is not required. In addition, filing Form 3115 is not required if the taxpayer decides to stop capitalizing repairs and maintenance costs in a subsequent year (after a year in which this election was made).

**Observation.** Many small taxpayers only keep books and records for tax purposes. This election gives these taxpayers a significant amount of latitude when preparing their current-year returns. This election also allows taxpayers who use long-range tax planning to maximize the tax benefits of their expenses over the lives of their assets.

<sup>33</sup> *Tangible Property Regulations — Frequently Asked Questions*. Mar. 13, 2015. Internal Revenue Service. [[www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection](http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyoumakeanelection)] Accessed on May 10, 2015.

<sup>34</sup> Treas. Reg. §1.263(a)-3(n).

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## Repairs and Improvements

	Election	Attachment Required
Facts and circumstances test	None	N/A
Partial dispositions election	By asset	No
Safe harbor election (regarding buildings) for small taxpayers	Annual	Yes
Safe harbor for routine maintenance	No	N/A
Election to capitalize repair and maintenance costs	Annual	Yes

### PARTIAL DISPOSITION ELECTION

The unit of property concept is extremely important as it applies to building systems. However, it also applies to all other assets with capitalized components. As a general rule, if a portion of an asset is replaced with a capitalized improvement, the cost of the improvement is added to the depreciation schedule. Moreover, **any remaining basis allocable to the portion of the asset that was replaced** remains on the depreciation schedule.

**Example 7.** Henry owns a commercial building, which he purchased in 2010. In 2015, he replaced one of two air conditioners. Under the facts and circumstances analysis, replacing the air conditioner is considered a restoration of a major portion of a building system. The expenditure must be capitalized.

Henry simply adds the cost of the new air conditioner to his depreciable building property. Any remaining basis attributable to the replaced air conditioner continues to be included in the basis of the building. Henry does not adjust the basis or accumulated depreciation of the building after the air conditioner replacement.

Under the regulations,<sup>35</sup> certain events automatically qualify as partial dispositions based on the nature of the events. In other situations, the taxpayer may **elect** to treat a portion of an asset as having been disposed of when the replacement for that portion is capitalized under the same asset class. The election must be made on a **timely filed (including extensions) original return** for the year of the disposition. **Generally, a taxpayer makes the election by reporting the gain, loss, or other deduction related to the disposition and properly capitalizing the improvement.**

**Note.** This election may be particularly beneficial for owners of real estate. Under the new regulations, such owners may not be able to expense costs incurred because the new regulations may require capitalization of those costs. However, this partial disposition election may provide the ability to deduct the amount of the adjusted basis remaining in an asset that was replaced.

**Example 8.** Use the same facts as **Example 7**. Henry identifies the portion of the original purchase price of the building that applied to the replaced air conditioner. He separates that cost and the accumulated depreciation allocable to that cost from his adjusted basis in the building. The adjusted basis of the old air conditioner is taken as a loss on his original 2015 return.

Henry adds the cost of the new unit to his depreciable assets using the same class life as the original unit. By treating the disposition and replacement consistently with the election, Henry has effectively made the partial disposition election for that asset for 2015.

<sup>35</sup> Treas. Reg. §1.168(i)-8.

## Exceptions to the Election Requirement

The taxpayer is not required to make a **timely** election to dispose of a portion of a unit of property under the following circumstances.

**Note.** For **exceptions 2 through 5**, the partial disposition rule must be used under the applicable Code sections. Consequently, if the taxpayer failed to report a gain or loss on a timely filed return for the year of the partial disposition in these circumstances, they may need to file Form 3115. See Rev. Proc. 2015-14, §6.38(4)(b).

1. An expense is capitalized as a result of an IRS examination (If an expense is capitalized by the IRS, the taxpayer may request a change in accounting method to treat the **replaced** unit of property as disposed of when it was replaced, provided the taxpayer owned the asset at the beginning of the year of change.<sup>36</sup> The taxpayer **is required** to file Form 3115 in this circumstance. See **Example 14** in the section “Filing Form 3115” later in this chapter.)
2. A disposition of a portion of an asset as a result of a casualty event<sup>37</sup>
3. A disposition of a portion of an asset for which gain is not recognized in whole or in part under IRC §§1031 or 1033<sup>38</sup>
4. A transfer of a portion of an asset in any transaction<sup>39</sup> described in IRC §§332, 351, 361, 721, or 731, and any transaction between members of the same affiliated group during any tax year for which a consolidated return is made by such group<sup>40</sup>
5. A sale of a portion of an asset

**Note.** For a calendar-year taxpayer, it is too late to file Form 3115 to make a **late** partial disposition election for any particular dispositions that occurred in closed tax years. The late election allowed under the proposed and final tangible property regulations must have been made with a **timely filed original** income tax return for any tax year beginning before January 1, 2015.<sup>41</sup>

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<sup>36</sup> Treas. Reg. §1.168(i)-8(d)(2)(iii).

<sup>37</sup> Treas. Reg. §1.168(i)-8(d)(1).

<sup>38</sup> Ibid.

<sup>39</sup> See IRC §168(i)(7)(B).

<sup>40</sup> Treas. Reg. §1.168(i)-8(d).

<sup>41</sup> Rev. Proc. 2015-14, §6.33; Treas. Reg. §1.168(i)-8(d)(2)(iv).



## Gain or Loss on Partial Dispositions<sup>42</sup>

Except in situations involving demolition of a structure,<sup>43</sup> the following rules apply when an asset is disposed of during a tax year. These general rules also apply to partial dispositions.

1. If an asset is disposed of by sale, exchange, or involuntary conversion, a gain or loss must be recognized.
2. If an asset is disposed of by physical abandonment, a loss must be recognized in the amount of the adjusted depreciable basis<sup>44</sup> of the asset at the time of the abandonment (taking into account the applicable convention). However, if the abandoned asset is subject to nonrecourse indebtedness, it may be necessary to recognize a gain on the disposition. For a loss from physical abandonment to be recognized, the taxpayer must intend to discard the asset **irrevocably** (so that the taxpayer will neither use the asset again nor retrieve it for sale, exchange, or other disposition).
3. The amount of loss may be limited if an asset is disposed of other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use. Examples of this type of disposition include transferring the asset to a supplies or scrap account. In this situation, no gain is recognized. The allowed loss is limited to the amount, if any, by which the adjusted depreciable basis exceeds the asset's fair market value (FMV) at the time of the disposition.

## Basis of the Disposed Portion of the Asset<sup>45</sup>

In calculating gain or loss, the adjusted basis of the disposed portion of the asset is the adjusted depreciable basis, as determined under the applicable convention for the asset. If determining the unadjusted depreciable basis<sup>46</sup> of the disposed portion of the asset is impracticable based on the taxpayer's records, the taxpayer may use **any reasonable method** for purposes of determining the unadjusted depreciable basis<sup>47</sup> of the disposed portion of the asset.

If the taxpayer disposes of more than one portion of the same asset, **the reasonable method used by the taxpayer must be consistently applied** to all portions of the same asset for purposes of determining the unadjusted depreciable basis of each disposed portion of the asset.

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<sup>42</sup> Treas. Reg. §1.168(i)-8(e).

<sup>43</sup> See IRC §280B and Treas. Reg. §1.280B-1.

<sup>44</sup> As defined in Treas. Reg. §1.168(b)-1(a)(4).

<sup>45</sup> Treas. Reg. §1.168(i)-8(f).

<sup>46</sup> As defined in Treas. Reg. §1.168(b)-1(a)(3).

<sup>47</sup> Ibid.

## Identification of the Disposed Portion of the Asset<sup>48</sup>

Generally, the taxpayer must specifically identify the asset disposed of and the particular tax year in which they placed the asset in service. If the taxpayer accounts for the asset in a multiple-asset account (or pool) but it is impracticable based on the taxpayer's records to determine the particular tax year in which the asset was placed in service, the taxpayer must identify the asset by using any applicable method listed in the following table.

Method	Description
First-in, first-out (FIFO) method	The taxpayer identifies the multiple-asset account with the earliest placed-in-service year that has the same recovery period as the asset disposed of and that has assets at the beginning of the tax year of the disposition. The taxpayer treats the portion of the asset disposed of as being from that asset.
Modified FIFO method	The taxpayer identifies the multiple-asset account with the earliest placed-in-service year that has the same recovery period as the asset disposed of and that has assets at the beginning of the tax year of the disposition with the same unadjusted depreciable basis as the asset disposed of. The taxpayer treats the portion of the asset disposed of as being from that multiple-asset account.
Mortality dispersion table	This method is used if the asset disposed of is part of a mass asset. The mortality dispersion table must be based on an acceptable sampling of the taxpayer's actual disposition experience for mass assets or other acceptable statistical or engineering technique. To use a mortality dispersion table, the taxpayer must adopt recordkeeping practices consistent with the taxpayer's prior practices and in accordance with good accounting and engineering practices.

**Note.** A **mass asset account** generally includes numerous small-value items, and each individual item has a minor value relative to the value of the overall group of mass assets in the account. It is generally impractical to separately identify any particular item in a mass asset account, and each item is not typically accounted for separately. Instead, the taxpayer accounts for the total dollar value. See Treas. Reg. §1.168(i)-8 for further details.

In addition to the preceding three methods, the IRS is authorized to provide other acceptable methods by publishing them in the Federal Register or in the Internal Revenue Bulletin.

**Note.** A last-in, first-out (LIFO) method of accounting **may not** be used. For information about disposed assets in multiple-asset accounts, see Treas. Reg. §1.168(i)-8.

<sup>48</sup> Treas. Reg. §1.168(i)-8(g).

## IRC §481(A) ADJUSTMENT OVERVIEW<sup>49</sup>

The Code allows a taxpayer to change their method of accounting from one tax year to another only with the IRS's approval. When the change would cause items of income or expense to be duplicated or omitted, the Code requires the calculation of an adjustment for the year of change to prevent such duplication or omission. This is referred to as the §481(a) adjustment.

The §481(a) adjustment is computed as of the beginning of the tax year for which the method is being changed. The adjustment represents the cumulative difference **without regard to the statute of limitations** between the present and proposed methods.

A net **positive** §481(a) adjustment increases income and may be referred to as a **taxpayer-unfavorable** adjustment. A net **negative** §481(a) adjustment decreases income and may be referred to as a **taxpayer-favorable** adjustment.

When a taxpayer uses a voluntary-method change procedure or a regulation provision, generally a net negative §481(a) adjustment is taken into account in the year of change. A **voluntary net positive §481(a) adjustment** is taken into account over **four years** starting with the year of change.

**Note.** When the IRS imposes a method change (an involuntary-method change) as a result of an examination, the entire net positive or negative §481(a) adjustment is generally taken into account in the year of change.

The IRS may determine that certain changes in accounting method will be made using a **cut-off method**, instead of a §481 adjustment.<sup>50</sup> Using a cut-off method, only the items arising on or after the beginning of the year of change are accounted for under the new method of accounting. Any items arising before the year of change continue to be accounted for under the taxpayer's former method of accounting. Because no items are duplicated or omitted from income when a cut-off method is used, no §481(a) adjustment is necessary. The cut-off method may be used in a taxpayer-initiated change only for a change specifically allowed or required by a statute or regulation or by the IRS in published guidance.

**Note.** Rev. Proc. 2015-20 is an example of the IRS using its authority to allow taxpayers to make changes using the cut-off method. This revenue procedure authorizes taxpayers to adopt certain methods of accounting under the tangible property regulations in 2014 without changing their accounting for past transactions. This is discussed later in the chapter.

Most automatic accounting method changes are granted with **audit protection**. This means that the IRS will not require the taxpayer to change their accounting method for the same item for a tax year prior to the year of change.<sup>51</sup> When the IRS does not give audit protection for a specific change, the revenue procedure authorizing the change specifically states that no audit protection is provided or that the audit protection is modified in certain circumstances.

**Example 9.** Heisenberg Industries has been using an impermissible method of accounting for certain items for several years. In 2015, Heisenberg files Form 3115 to change to a proper method of accounting for these items. If the change is made with audit protection, the IRS cannot propose an adjustment for the improper method of accounting for these items in an examination of a tax year prior to 2015.

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<sup>49</sup> IRM 4.11.6 (2005).

<sup>50</sup> IRM 4.11.6.5.5 (5/13/2005) and Treas. Reg. §1.446-1(e)(3)(ii).

<sup>51</sup> IRM 4.11.6.6.4 (5/13/2005).

**Observation.** This is an incentive to encourage the taxpayer to voluntarily change from an impermissible method to a permissible method when the change results in a positive §481(a) adjustment. If the IRS were to discover the error during an audit, the taxpayer would not be subject to interest or penalties on understatement of tax related to that error because the taxpayer already used an IRS-approved method to correct it.

**Example 10.** Werner Principles has been improperly treating the office equipment it uses as leased assets. Review of the lease agreement shows that the office equipment was actually purchased under a 2013 purchasing agreement.

In 2015, Werner purchases additional equipment using the same purchasing agreement and wants to account for the new equipment properly. With its 2015 return, Werner files Form 3115 using the automatic consent procedures (discussed later) provided in §6.03 of Rev. Proc. 2015-14. This change of accounting method is made using a cut-off method, and it applies only to transactions occurring on or after the beginning of the year of change.<sup>52</sup> The IRS specifically states that audit protection is **not** granted for this change.<sup>53</sup>

**Note.** In **Example 10**, if Werner wants to change its accounting method for financing transactions entered into **before** the beginning of the year of change, it must file a request under the nonautomatic change procedures of Rev. Proc. 2015-13. The fee for this application is determined under Rev. Proc. 2015-1<sup>54</sup> or its successor. Depending on Werner's 2015 gross income, the fee will be \$2,200 (gross income under \$250,000), \$6,500 (gross income of \$250,000 to \$999,999), or \$8,600 (gross income of \$1 million or more).

## 2015 REVENUE PROCEDURES AFFECTING TANGIBLE PROPERTY

In 2015, the IRS issued three new revenue procedures to update various aspects associated with filing Form 3115. Two of these revenue procedures updated all the procedures for filing Form 3115. The other procedure was issued in direct response to the concerns about every taxpayer needing to file Form 3115 to adopt accounting procedures that are consistent with the new tangible property regulations.

This section addresses in detail only the aspects of the new revenue procedures specifically related to the tangible property regulations.

### REVENUE PROCEDURES APPLICABLE TO ALL TAXPAYERS

Rev. Proc. 2015-13<sup>55</sup> updates and revises the general procedures to obtain the IRS's consent to change a method of accounting for federal income tax purposes. One notable change is that it allows the taxpayer to elect a 1-year adjustment period for a positive §481(a) adjustment that is less than \$50,000.

Rev. Proc. 2015-14<sup>56</sup> provides the current list of changes that may be made using the automatic change procedures and specific instructions for each change. These changes are reported on a revised Form 3115.

**Note.** The revenue procedures simply allow the taxpayer to complete fewer sections of Form 3115 under certain circumstances. Rev. Proc. 2015-13 establishes the general information that must be included on every short Form 3115. Rev. Proc. 2015-14 lists the specific lines and sections of Form 3115 that must be completed.

<sup>52</sup> Rev. Proc. 2015-14, §6.03(2)(a).

<sup>53</sup> Rev. Proc. 2015-14, §6.03(3).

<sup>54</sup> Rev. Proc. 2015-1, 2015-1 IRB 1.

<sup>55</sup> Rev. Proc. 2015-13, 2015-5 IRB 419.

<sup>56</sup> Rev. Proc. 2015-14, 2015-5 IRB 450.

## SIMPLIFIED PROCEDURE FOR SMALL BUSINESS TAXPAYERS

The IRS did not intend to make complying with the new tangible property regulations burdensome for taxpayers — especially small business taxpayers. The simplified procedure under Rev. Proc. 2015-20<sup>57</sup> was designed to make it easier for small business taxpayers to adopt accounting procedures consistent with the new regulations.

### Small Business Taxpayer Defined<sup>58</sup>

To qualify to use these simplified procedures, a small business taxpayer must meet **one** of the following conditions.

1. Be a taxpayer with total **assets of less than \$10 million** as of the first day of the tax year for which a change in accounting method is effective
2. Have a separate and distinct trade or business with **average annual gross receipts of \$10 million or less** for the prior three tax years (Average annual gross receipts for this purpose are calculated using the same method as used for the small business safe harbor election.<sup>59</sup>)

The simplified procedure is applied to each separate and distinct trade or business owned by the taxpayer. If the taxpayer has more than one separate and distinct trade or business, they can choose the simplified procedure only for the trades or businesses that meet at least one of the preceding criteria. Therefore, the taxpayer may be in a situation in which they can apply the simplified procedure to some of their businesses but not others.

### Simplified Procedure: Advantages and Disadvantages

In addition to simplification, **advantages** of using the simplified procedure include the following.

1. It does not require analyzing transactions reported in tax years beginning before January 1, 2014, in order to compute the §481(a) adjustment.
2. Filing Form 3115 is not required if the change is made by adopting the method with the tax return filed for the **first tax year beginning on or after January 1, 2014.**

Using the simplified procedure also involves a few **disadvantages** for small businesses.<sup>60</sup>

1. Changing the treatment of transactions that occurred in tax years beginning before January 2014 is not permitted. This includes dispositions of tangible property that occurred in prior years that, if included, might have created a larger §481(a) negative adjustment.
2. **No audit protection** is provided for transactions occurring in tax years beginning before January 2014 that were reported using the prior accounting method. (See the section “IRC §481(a) Adjustment Overview” for more information about audit protection and changes in accounting method.)
3. The simplified method must be used for **all** accounting procedure changes that the taxpayer makes if the changes fall under Rev. Proc. 2015-20.

Only certain accounting methods may be changed using the simplified procedure. These are covered in more detail later in this chapter in the section “Filing Form 3115.”

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<sup>57</sup> Rev. Proc. 2015-20, 2015-9 IRB 694.

<sup>58</sup> Ibid.

<sup>59</sup> See Treas. Reg. §1.263(a)-3(h)(3).

<sup>60</sup> Rev. Proc. 2015-20, 2015-9 IRB 694.

## Simplified Procedure for Changes in Accounting Methods

Rev. Proc. 2015-20<sup>61</sup> was issued specifically to address the burden of retroactively changing accounting procedures to comply with the new tangible property regulations. It provides two procedures for the small business taxpayer to make changes to their accounting method for certain depreciable items, discussed later in this chapter.

Under the **first simplified procedure**, the taxpayer **does not file Form 3115**. The taxpayer simply adopts the method with the tax return filed for the **first tax year beginning on or after January 1, 2014**. No adjustment is made for different methods used prior to January 1, 2014.

**Example 11.** Belle's Bridal Shop (Belle) is a small business as defined by Rev. Proc. 2015-20. In 2014, Belle decided to adopt the safe harbor for routine maintenance as its accounting procedure for 2014 and subsequent years.

This is the accounting procedure that Belle uses to determine if an expenditure is categorized as a repair or an improvement. Belle is not required to review transactions prior to January 1, 2014, in order to see whether the items were properly capitalized or expensed.

**Note.** For a calendar-year taxpayer who has already filed their 2014 return, the option to make the change without filing Form 3115 is no longer available.

The **second simplified procedure** applies to taxpayers who did not change their method of accounting in 2014 for items affected by the new tangible property regulations. Under this procedure, **the taxpayer files Form 3115** but only makes an adjustment for transactions occurring **on or after January 1, 2014**. This cut-off date is in contrast to the usual procedure, which requires that the adjustment include all prior-year transactions affected by the change in accounting procedure.

**Example 12.** Buster's Tuxedo Depot (Buster) is a small business, as defined by Rev. Proc. 2015-20. In 2017, Buster wants to change its method of identifying separate building components to capitalize types of expenditures that were previously expensed. In 2014, Buster replaced both furnaces in the building it owned. On the company's 2014 return, this replacement was expensed as a repair. Under the tangible property regulations, the furnaces are part of the HVAC key building system. Replacement of both furnaces should have been treated as a restoration, and the cost should have been capitalized.

To comply with the regulations, Buster determines that it must file Form 3115 to correct the method it used to identify the building systems. In addition to making an adjustment for the 2014 transaction, Buster must analyze all transactions relating to the building systems. Under this simplified procedure, Buster only calculates the §481(a) adjustment using transactions that occurred after January 1, 2014. Buster files Form 3115 with its 2017 return using the rules for this designated automatic accounting method change (which are found in §10.11 of Rev. Proc. 2015-14).<sup>62</sup>

**Note.** Under the rules in place before the IRS established the simplified procedures, Buster would have been required to review every transaction related to building components starting with the date that it first placed the building into service.

<sup>61</sup> Rev. Proc. 2015-20, 2015-9 IRB 694.

<sup>62</sup> Rev. Proc. 2015-14, 2015-5 IRB 450.

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The following table summarizes the **only types of changes in accounting methods that can be made using the simplified procedure.**

Type of Change in Accounting Method	Section of Rev. Proc. 2015-14	Description of Change in Accounting Method
Certain changes from one permissible method to another permissible method for assets in multiple accounts	§§6.37 (3)(a)(iv), (v), (vii), (viii)	This change involves the methods used to identify which assets (or which portion of assets) in multiple-asset accounts have been disposed of as permitted under Treas. Reg. §1.168(i)-8(g).
Changes related to the disposition of buildings or structural components of buildings	§6.38	<p>These rules apply to a taxpayer who wants to make a change in the method of accounting for:</p> <ul style="list-style-type: none"> <li>• Disposing of a building or a structural component thereof, or</li> <li>• Disposing of a portion of a building (including its structural components) to which the partial disposition rule applies.</li> </ul> <p>This change does not apply to any disposition of a portion of an asset for which a partial disposition election<sup>63</sup> is required but for which the taxpayer did not make such an election.</p> <p>This change also affects the determination of gain or loss from disposing of the building, the structural component, or the portion of the building (including its structural components). It may also affect whether the taxpayer must capitalize the amounts paid to restore a unit of property.</p>
Certain dispositions of tangible depreciable assets ( <b>other than</b> a building or its structural components)	§6.39	<p>This change applies to dispositions of the following types of property.</p> <ul style="list-style-type: none"> <li>• §1245 property</li> <li>• Depreciable land improvements</li> <li>• Portions of §1245 property or depreciable land improvements.</li> </ul> <p>This change does not apply to any disposition of a portion of an asset for which a partial disposition election<sup>64</sup> is required but for which the taxpayer did not make such an election.</p> <p>This change also affects the determination of gain or loss from disposing of these types of property. It may also affect whether the taxpayer must capitalize the amounts paid to restore a unit of property.</p>
Certain tangible property changes	§10.11	<p>This section applies to a change <b>to deducting</b> amounts paid or incurred for repair and maintenance or a change <b>to capitalize</b> amounts paid or incurred for improvements to tangible property and depreciating qualifying property.</p> <p>This change may also involve a change in the method of identifying the unit of property, or in the case of a building, identifying the building structure or building systems for the purpose of making this change. Many additional changes are included in this section.</p>

<sup>63</sup> Under Treas. Reg. §1.168(i)-8(d)(2).

<sup>64</sup> Ibid.



## IS A CHANGE IN ACCOUNTING METHOD NECESSARY OR ADVISABLE?

Every business taxpayer has a method of accounting for tax purposes. The method may be adopted through written procedures or through filing a tax return. The following series of questions and observations include references to recent developments that are explained in detail elsewhere in the chapter.

Practitioners may want to consider the following questions to determine if their clients should make changes in their accounting methods and, if so, what procedures should be followed.

1. What accounting methods does the taxpayer currently use?
2. Are methods currently used by the taxpayer permissible methods?
  - A taxpayer whose method of accounting complies with the tax rules for capitalization and repairs does **not need** to make a change in accounting method in order to continue being in compliance. Therefore, they are **not required** to file Form 3115.
  - A taxpayer who chooses to make **elections** or forgoes making elections is not changing their method of accounting. They are **not required** to file Form 3115.<sup>65</sup>
  - Once a taxpayer adopts a proper method of accounting by filing a return using that method, they may **not** adopt a different method of accounting by filing an amended return. To change the method of accounting, the taxpayer must file Form 3115 even if the previous method was used only on one return.<sup>66</sup>
3. Is the taxpayer using impermissible methods that have caused their tax liabilities to be significantly misstated? If a mistake affects only one tax return, the affected return can be amended without filing Form 3115.<sup>67</sup> The amended return must be filed **prior** to filing the next year's return.<sup>68</sup>

**Note.** In discussing the practitioner's duty to advise clients about noncompliance errors or omissions, Circular 230 does not provide an exception for immaterial or insignificant errors. Logically, however, it is impractical to correct every mistake. Even the Internal Revenue Manual (IRM) directs IRS examiners to analyze the likelihood that there are no material errors.<sup>69</sup>

The American Institute of CPAs (AICPA) Statement on Standards for Tax Services No. 6, *Knowledge of Error: Return Preparation and Administrative Proceedings* (SSTS No. 6), states that "an error does not include an item that has an insignificant effect on the taxpayer's tax liability." Both §10.21 of Circular 230 and SSTS No. 6 require the tax practitioner to notify the taxpayer of any errors found and the potential consequences of the error. If the statute of limitations has expired, the error may not have any consequences.

<sup>65</sup> *Tangible Property Regulations — Frequently Asked Questions*. Mar. 13, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Tangible-Property-Final-Regulations#Whenandhowdoyouapply] Accessed on Jun. 9, 2015.

<sup>66</sup> IRM 4.11.6.3 (05/13/2005).

<sup>67</sup> Rev. Rul. 72-491, 1972-2 CB 104 and Rev. Rul. 90-38, 1990-1 CB 57.

<sup>68</sup> IRM 4.11.6.3 (5/13/2005).

<sup>69</sup> IRM 4.10.3.5 (3/1/2003).

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4. If the accounting methods used by the taxpayer are **not compliant** with the new tangible property regulations, what must the taxpayer do to become compliant? Options include the following.
- The new tangible property regulations generally became effective on January 1, 2014. If the area of noncompliance was consistent with prior regulations, the 2014 return can be amended and the new accounting procedures used for 2015 and subsequent years.
  - The method can be changed using the cut-off procedures under Rev. Proc. 2015-20.<sup>70</sup> Doing so requires filing Form 3115. However, the IRC §481(a) adjustment will include only transactions that occurred in tax years beginning after January 1, 2014.
  - The method can be changed by filing Form 3115 and making a §481(a) adjustment on the current return using the standard method of calculating the adjustment. The §481(a) adjustment will include all transactions treated improperly in all prior tax years.
  - If the improper method was used on two consecutive returns, the taxpayer has established a method of accounting. Amended returns may not be used to change the method of accounting. Form 3115 is required to institute a change to a permissible method.

**Note.** The IRS may detect noncompliance in an examination. As a result, a taxpayer **not in compliance** may be required to include the **entire §481(a) adjustment** in income in the year under audit (instead of spreading the adjustment over four years, as allowed when a taxpayer voluntarily becomes compliant.) Furthermore, the additional taxes are subject to interest and potential penalties depending on the size of the adjustment. For example, if the adjustment to the tax liability is more than \$5,000, the taxpayer may be subject to the negligence penalty under IRC §6662(c).

5. For small business taxpayers, can the adjustment be calculated using a new simplified procedure under which only transactions that occurred after January 1, 2014, are included in the adjustment?
6. If the taxpayer is **in compliance**, are the methods being used producing the best tax result?

Even taxpayers in compliance may wish to adopt one or more of the methods approved under the current rules instead of continuing to use their existing accounting procedures. Such a change may be made to produce a more favorable tax result, or it may be made because a change in the taxpayer's methods of tracking their assets makes the old method impractical.

**Example 13.** Carol Capitalizit has her own CPA firm. She has always insisted that her clients capitalize all expenditures that appeared to be restorations. As a result, all of her clients have adopted the accounting method of capitalizing routine maintenance if the expenditures were for the replacement of an entire category of property (such as flooring).

After reviewing the tangible property regulations, Carol realizes that many of these expenditures fall under the safe harbor for routine maintenance. She prepares a Form 3115 for each of her clients to change their accounting methods to deduct all expenditures qualifying for the safe harbor.

<sup>70</sup> Rev. Proc. 2015-20, 2015-9 IRB 694.

## Observations for Example 13.

1. The procedures for making this change are found in Rev. Proc. 2015-14,<sup>71</sup> §10.11.
2. The designated automatic accounting method change number to use on Form 3115 is 184.<sup>72</sup>
3. For qualified small business clients, Carol may use the new short Form 3115.
4. Changing the method of accounting for these types of transactions will result in an adjustment on each client's tax returns for the year the change is implemented.
5. The adjustment may be calculated by changing the treatment of all items previously capitalized (using the §481(a) adjustment, discussed earlier in the chapter).

The best tax result varies based on the taxpayer's individual circumstances and tax year. The options available for changing to the preferred method and the costs and benefits of each option should be considered.

Included in the cost of changing the accounting method is the time it takes to review transactions reported in prior tax years and compute potential adjustments for the current year. This may make using the Rev. Proc. 2015-20<sup>73</sup> procedures for small businesses more attractive than the standard procedures. Under Rev. Proc. 2015-20, only transactions that occurred in tax years beginning after January 1, 2014, are included in the §481(a) adjustment. Under the standard procedures, **every** transaction that relates to the change in accounting method is included in the §481(a) adjustment.

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## FILING FORM 3115

### GENERAL PROCEDURES

Generally, the taxpayer must obtain IRS consent to change from a current accounting method to a new accounting method.<sup>74</sup> Rev. Proc. 2015-13<sup>75</sup> provides the general procedures for obtaining IRS consent to change accounting methods. This supersedes the previous guidance provided under Rev. Proc. 97-27 as amplified, clarified, and modified by subsequent revenue procedures.

Rev. Proc. 2015-14<sup>76</sup> provides the **entire list of automatic changes allowed as of the date it was issued (January 16, 2015)** and specific procedures for each automatic change. This procedure is effective for a Form 3115 filed on or after January 16, 2015, for a year of change ending on or after May 31, 2014. It supersedes Rev. Proc. 2011-14.

The address of the appropriate IRS center to which a copy of Form 3115 should be mailed varies depending on the change being made and the type of entity making the change. The addresses are provided in the instructions. However, **the address for Ogden, Utah, has been updated from the one shown in the Form 3115 instructions.** The new address follows.<sup>77</sup>

**Internal Revenue Service  
1973 Rulon White Blvd.  
Mail Stop 4917  
Ogden, UT 84201-1000**

<sup>71</sup> Rev. Proc. 2015-14, 2015-5 IRB 450.

<sup>72</sup> Ibid.

<sup>73</sup> Rev. Proc. 2015-20, 2015-9 IRB 694.

<sup>74</sup> IRC §446(e); *Hawse v. Comm'r*, TC Memo 2015-99 (May 28, 2015).

<sup>75</sup> Rev. Proc. 2015-13, 2015-5 IRB 419.

<sup>76</sup> Rev. Proc. 2015-14, 2015-5 IRB 450.

<sup>77</sup> *Change of Mailing Address for Form 3115, Application for Change in Accounting Method — 20-FEB-2015*. Feb. 23, 2015. Internal Revenue Service. [www.irs.gov/uac/Recent-Development-2015-02-20-2009-Form-3115] Accessed on Jun. 24, 2015.

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## Important Procedural Elements of Filing Form 3115<sup>78</sup>

**Note.** See the instructions for Form 3115 for procedures applicable to controlled foreign corporations, noncontrolled section 902 corporations (10/50 corporations), and consolidated groups. This information is not included in this chapter.

**When and Where To File.** Except as otherwise specifically provided, Form 3115 is filed in duplicate as follows.

1. The **original** Form 3115 is attached to the taxpayer's timely filed (including extensions) federal income tax return for the year of change.
2. A **copy** of Form 3115 is filed with the IRS national office, unless Rev. Proc. 2015-14 or other published guidance requires filing the copy with the IRS office in Ogden, Utah. The copy must be filed no earlier than the first day of the year of change and no later than the date the original is filed with the federal income tax return for the year of change.

**Name and Signature.** In general, the taxpayer is the filer and applicant of the Form 3115. In certain cases involving consolidated groups and other multiple taxpayers, the applicant and the filer may not be the same entity. These situations require obtaining multiple signatures.

For changes requested under the automatic consent procedures, the filer must attach a copy of Form 3115 to the return for the year of change. In addition, the filer must send a signed and dated copy of Form 3115 to the IRS national office or the office in Ogden, Utah. If the individual preparing Form 3115 is not the applicant, the preparer must sign the application. However, the copy of Form 3115 **attached to the income tax return** does **not** need to be signed.

In every case, someone who signs on behalf of the applicant must have personal knowledge of the facts and the authority to bind the filer in the matter.

**Individuals.** If Form 3115 is filed for spouses who file a joint income tax return, the names of both spouses are included on the first line of the application. Both spouses must sign on the signature line.

**Partnerships.** One of the general partners or limited liability company members must sign on behalf of a partnership.

**Corporations.** For a nonconsolidated corporation, personal service corporation, S corporation, cooperative, or insurance company, Form 3115 must be signed by an officer of the entity.

**Estates and Trusts.** For an estate or trust, Form 3115 must be signed by the fiduciary, personal representative, executor, administrator, or person acting in one of these capacities.

**Exempt Organizations.** For an exempt organization, a principal officer or person with a similar role must sign Form 3115.

**Form 2848.** If a tax practitioner wants to be able to communicate directly with the IRS about the request for a change in accounting method, the IRS must have Form 2848, *Power of Attorney and Declaration of Representative*, on file. The taxpayer must sign Form 2848. For an entity, a person with the authority to appoint a representative must sign.

Form 2848 must specifically authorize the practitioner to represent the filer before the IRS regarding the requested change in accounting method. A copy of the signed Form 2848 must be attached to the copy of Form 3115 that is mailed to the IRS national office or the office in Ogden, Utah. Without a signed Form 2848, the IRS will not discuss the application with the taxpayer's representative, even if that representative prepared and/or signed the Form 3115.

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<sup>78</sup> Instructions for Form 3115.

**Option to Receive Correspondence by Fax.** An applicant may request that the IRS correspond with them by fax instead of by mail regarding Form 3115. This request is made by attaching a statement to Form 3115. The statement must list the names and fax numbers of the persons who are to receive the fax. The listed persons must be authorized to sign Form 3115 or a representative who is authorized on Form 2848.

**Additional Information.**<sup>79</sup> The IRS may request additional information when it processes the request for a change in accounting method. The applicant must respond within a certain time frame, depending on whether the request is under the automatic or nonautomatic change procedures. The IRS may impose shorter reply periods for subsequent requests for additional information.

The IRS may grant an extension of time to furnish information. Any request for an extension of time must be made in writing and submitted before the end of the original deadline. If unusual circumstances make issuing a written request impractical, the taxpayer should notify the IRS before the deadline explaining that there is a problem and that the written request for extension will be provided soon.

The IRS representative reviewing the application has the authority to grant or deny the extension. If the additional information should have been included with Form 3115 according to the instructions, an extension is usually denied. The taxpayer is told promptly of the approval or denial of the requested extension. If the extension request is denied, there is no right of appeal.

If the required information is not furnished to the IRS within the reply period, the IRS notifies the taxpayer that the request to change the accounting method has been denied. If the taxpayer wants to submit the additional information at a later date, they must submit it with a new Form 3115 (plus user fee, if applicable). If the deadline for the timely filing of Form 3115 has passed, the change will be effective for the year in which the new form is timely filed.

**Penalties of Perjury Statement for Additional Information.** Additional information submitted to the IRS must be accompanied by the following declaration.

*Under penalties of perjury, I declare that I have examined this information, including accompanying documents, and, to the best of my knowledge and belief, the information contains all the relevant facts relating to the request for the information, and such facts are true, correct, and complete.*

This declaration must be signed by the taxpayer or by a duly authorized person acting on behalf of the entity.

**Note.** Form 3115 may **not** be submitted via fax.<sup>80</sup> However, additional information requested by the IRS may be submitted by fax. A copy of the additional information and the signed penalties of perjury statement must also be mailed to the IRS representative who requests the information.

**Requesting a Conference.**<sup>81</sup> As a matter of right, a taxpayer is entitled to one conference with the IRS regarding the application if the IRS indicates that it will reject or disallow the change in accounting method. However, once the request for change has been denied, the taxpayer does **not** have the right to appeal to any IRS official.

The applicant may request a conference by checking the box in part II on line 18 of the original Form 3115. Alternatively, the applicant may make the request in writing after the IRS has indicated that it plans to deny the application.

<sup>79</sup> Rev. Proc. 2015-1, 2015-1 IRB 1.

<sup>80</sup> Rev. Proc. 2015-1, 2015-1 IRB 1.

<sup>81</sup> Ibid.

Depending on the circumstances, a conference may be held by telephone. The taxpayer may request a telephone conference for various reasons. For example, the taxpayer may believe that the issue involved does not warrant the expense of traveling to Washington, DC, or to Ogden, Utah. The IRS has the authority to decide if holding a telephone conference is appropriate in any particular situation. If the request is approved, the taxpayer will be advised when to call the IRS.

After the conference, the taxpayer should furnish the IRS with any additional data, reasoning, precedents, and so on that they proposed and discussed at the conference but did not previously or adequately present in writing. The taxpayer must furnish the additional information within **21 calendar days** from the date of the conference.

**Reliance on IRS Consent.**<sup>82</sup> If the national office determines that the consent to a change in accounting method was issued in error or is not in accordance with the IRS's current views, it may revoke or modify its consent by issuing a notice of revocation or modification to the taxpayer. Except in rare and unusual circumstances, if a taxpayer changes their accounting method and is subsequently required to change or modify that accounting method, the required change or modification will not be applied retroactively if **all** of the following conditions are met.

1. The taxpayer complied with all the applicable provisions.
2. The taxpayer neither misstated nor omitted any material facts.
3. The material facts on which the consent was based have not changed.
4. The applicable law has not changed.
5. The taxpayer to whom consent was granted acted in good faith in relying on the consent, and applying the change in accounting method or modification retroactively would be to the taxpayer's detriment.

### **Automatic Consent Procedures**<sup>83</sup>

Only the changes listed in Rev. Proc. 2015-14 (or its successors) may be made under the automatic consent procedures. If the taxpayer meets the conditions and follows the procedures in Rev. Proc. 2015-14, they are deemed to have automatically received IRS consent to make the change. **No fee is required for applications filed under the automatic consent procedures.** The IRS does not acknowledge its approval of applications filed under these procedures.

Generally, a taxpayer may receive automatic consent to change an accounting method by completing and filing Form 3115 and **including it with the timely filed original federal tax return** for the year of change. A signed copy of Form 3115 must also be filed with the appropriate office.

A taxpayer generally may **not** use the automatic consent procedures under the following circumstances. (However, there a number of exceptions, and Rev. Proc. 2015-13 should be consulted if the taxpayer appears to fall under one of these prohibitions.)

1. Within the requested year of change, the taxpayer engages in a liquidation or reorganization transaction to which IRC §381(a) applies.
2. The requested year of change is the final year of the trade or business.
3. The taxpayer has made or requested an overall method change during any of the five tax years ending with the year of change.
4. The taxpayer has made or requested a change for the same item during any of the five tax years ending with the year of change.

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<sup>82</sup> Rev. Proc. 2015-13, 2015-5 IRB 419.

<sup>83</sup> Rev. Proc. 2015-13, 2015-5 IRB 419 and Rev. Proc. 2015-14, 2015-5 IRB 450.



If the IRS requires more information after reviewing the requested change, it will notify the taxpayer. In general, additional information must be furnished in writing within **30 calendar days** from the date of the request. The IRS may grant the applicant an additional 30 calendar days to provide the information if the applicant requests an extension and the IRS deems it appropriate.<sup>84</sup>

A qualifying taxpayer complying with an automatic change request procedure may assume that IRS consent has been granted. However, this is true only if:

- The affected item(s) are clearly and expressly identified in the taxpayer's Form 3115, **and**
- The taxpayer complies with all the applicable provisions and implements the change on their federal income tax return for the requested year of change.<sup>85</sup>

**Note.** In addition to changes related to the tangible property regulations, Rev. Proc. 2015-14 covers the procedures for all other accounting method changes allowed under the automatic consent procedures. Practitioners might be interested in §9 regarding computer software expenditures, §14 regarding changes in overall methods of accounting, or §6.17 relating to a change from an impermissible to a permissible method of accounting for depreciation or amortization for disposed depreciable or amortizable property. This last change is a powerful tool to offset the allowed or allowable rule when less than the allowable amount of depreciation was taken.

## Nonautomatic Change Requests<sup>86</sup>

A taxpayer who does not qualify to use the automatic consent procedures or who requests a change not included in the list of automatic changes may request IRS approval for a nonautomatic change (previously known as advance consent procedures). Form 3115 requesting a nonautomatic change generally must be filed **during the year of the requested change**.

User fees apply to most of the changes requested under the nonautomatic change procedures. A list of the applicable fees can be found in Rev. Proc. 2015-1<sup>87</sup> (or its successor).

If the IRS requires more information after reviewing the requested change, it notifies the taxpayer. In general, additional information must be furnished in writing within **21 calendar days** from the date of the request. The IRS may grant the applicant an additional 15 calendar days to provide the information if the applicant requests an extension and the IRS deems it appropriate.

The IRS has the right to decline to process any nonautomatic changes requested on Form 3115 in situations in which it would not be in the best interest of sound tax administration to permit the requested change. In this regard, the IRS considers whether the change in method of accounting clearly and directly frustrates compliance efforts of the IRS in administering the income tax laws.

<sup>84</sup> Rev. Proc. 2015-1, 2015-1 IRB 1.

<sup>85</sup> Rev. Proc. 2015-13, 2015-5 IRB 419.

<sup>86</sup> Rev. Proc. 2015-1, 2015-1 IRB 1.

<sup>87</sup> Ibid.



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## PROCEDURES RELATED TO THE TANGIBLE PROPERTY REGULATIONS

The following sections of Rev. Proc. 2015-14 include instructions for automatic changes in accounting methods under the new tangible property regulations.

- §6.37: Permissible to permissible method of accounting for depreciation of MACRS property for property in pooled or general asset accounts (GAAs)
- §6.38: Disposition of buildings or structural components
- §6.39: Dispositions of §1245 property and depreciable land improvements
- §6.40: Dispositions of tangible depreciable assets in a GAA<sup>88</sup>
- §10.11: Certain tangible property changes

These automatic changes in accounting methods for tangible property have a number of procedures in common and only minor differences. The following procedures apply to all five sections listed previously.

1. A single Form 3115 may be used for more than one accounting method change. Practitioners using Form 3115 for multiple changes should review Rev. Procs. 2015-13 and 2015-14 for additional guidance.
2. A taxpayer may use statistical sampling to determine the §481(a) adjustment amount. Specific guidance on statistical sampling for this purpose is provided in Rev. Proc. 2011-42.

All of these changes qualify for the revised Form 3115 procedures for small business taxpayers. As mentioned earlier, for this purpose, small business taxpayers are those with average annual gross receipts of \$10 million or less. The specific instructions for each section indicating which portions of Form 3115 small business taxpayers must complete are summarized in the following table.

**Revised Form 3115 Requirements for Small Taxpayers**

Change Section	§6.37	§6.38	§6.39	§6.40	§10.11
The identification section of page 1 (above Part I)	X	X	X	X	X
The signature section at the bottom of page 1	X	X	X	X	X
Part I	X	X	X	X	line 1(a) only
Part II					
Lines 4–12, 14, and 18	X	X	X	X	X
Line 15, if the change involves depreciating property					X
Part IV					
Line 25	X				
Lines 26 and 27	X	X	X	X	X
Schedule E					
Line 3	X	X	X	X	
Lines 4a through 4c	X				
All lines if the change involves depreciation or amortization					X
Additional information required in attachment <sup>a</sup>		X	X	X	X
Statistical sampling may be used to calculate §481(a) adj.		X	X		X
Designated automatic change number	200	205	206	207	See Chart

<sup>a</sup> See the detailed explanations for each section later in the chapter for a list of the additional information that is required.

**Note.** Special rules apply to public utility property<sup>89</sup> under all these sections. These rules are not covered in this chapter.

<sup>88</sup> IRC §168(i)(4) and Treas. Reg. §1.168(i)-1.

<sup>89</sup> IRC §168(i)(10).

The instructions for each section specify which changes are combined into one net §481(a) adjustment and which are separated into two categories — positive adjustments and negative adjustments — if §481(a) is applicable. If the changes result in two categories of §481(a) adjustments, the net negative adjustments are treated under the provisions for immediate recognition, and the net positive adjustments may be recognized over four years.

## §6.37: Permissible to Permissible Method for Depreciation for Pooled Assets or GAAs

As mentioned previously, this set of changes is included within the automatic change procedures. Because the original accounting method was permissible, a change can be made only by filing Form 3115. The designated automatic accounting method change number for a change to a method of accounting under this section is **200**.

Section 6.37 of Rev. Proc. 2015-14 applies only to the changes in accounting methods for depreciation of MACRS property in multiple-asset (i.e., pooled) accounts or GAAs.

**Note.** For more information about GAAs, see the 2012 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues. This is available at [uofi.tax/arc](http://uofi.tax/arc) [[www.taxschool.illinois.edu/taxbookarchive/](http://www.taxschool.illinois.edu/taxbookarchive/)].

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To make it easier to calculate MACRS depreciation, a taxpayer may group separate properties into one or more GAAs.<sup>90</sup> All the assets in a given GAA are depreciated as a single item of property. The election is made on a timely filed tax return (including extensions) by completing line 18 of Form 4562, *Depreciation and Amortization*, for the year in which the property is placed in service.

The changes under this section can be grouped into three categories.

1. Changes related to assets that are **not** subject to the GAA election that **qualify** for the simplified procedures for small business taxpayers
2. Changes related to assets that are **not** subject to the GAA election that **do not qualify** for the simplified procedures for small business taxpayers
3. Changes related to assets that are subject to a GAA election (None of these changes qualify for the simplified procedures.)

A complete list of the changes that may be made under this procedure is provided in the appendix to this chapter. The method of making the adjustment is also specified for each change. Some changes require a §481(a) adjustment (explained earlier in the chapter); some require making the change using the cut-off method; and others require the taxpayer to use a modified cut-off method.

**Definition of the Cut-Off Method.** Under the cut-off method, only the items arising on or after the beginning of the year of change are accounted for under the new method of accounting. Any items arising before the year of change continue to be accounted for under the taxpayer's former method of accounting. Because no items are duplicated or omitted from income when a cut-off method is used, no §481(a) adjustment is necessary.

**Definition of the Modified Cut-Off Method.** Under the modified cut-off method, the unadjusted depreciable basis and the asset's depreciation reserve as of the beginning of the year of change are accounted for using the proposed method of accounting. See Rev. Proc. 2015-14, §6.37(4)(a), for specific instructions for each change made using this method.

## §6.38: Disposition of Buildings or Structural Components

As mentioned previously, this set of changes is included within the automatic change procedures. All of these changes may be made using the simplified procedures under Rev. Proc. 2015-20. The designated automatic accounting method change number for a change to a method of accounting under this section is **205**.

<sup>90</sup> IRS Pub. 946, *How To Depreciate Property*.

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Section 6.38 of Rev. Proc. 2015-14 covers the applicable rules for a change in the accounting method related to the following.

- Disposing of a building or a structural component
- Disposing of a portion of a building (including its structural components) to which the **partial disposition rule** applies

**Note.** Changes relating to partial dispositions may only be of the type that does **not require an election** on the original return.<sup>91</sup> See the exceptions in the section “Partial Disposition Election,” earlier in this chapter.

A change of accounting method for dispositions affects the determination of gain or loss from disposing of these assets. It may also affect whether the taxpayer must capitalize amounts paid to restore a unit of property.

A taxpayer should make a change under this set of procedures if they want to change their method of identifying which assets or portions of assets have been disposed of or if they need to correct a partial disposition occurring in a prior year. A taxpayer should also use this set of procedures if they need to remove an asset from the depreciation schedule to claim a gain or loss that occurred in a prior year. Finally, a taxpayer should use this set of procedures to change how they determine the unadjusted basis of assets that have been disposed of. A complete list of the changes that may be made under this procedure is provided in the appendix to this chapter.

These change procedures do **not apply** to the following.

1. Any multiple buildings, condominium units, or cooperative units that are treated as a **single building** under the taxpayer’s present method of accounting or that will be treated as a single building under the taxpayer’s proposed method of accounting<sup>92</sup>
2. Any disposition of a portion of an asset for which a partial disposition election<sup>93</sup> is required but for which the taxpayer **did not make such election**
3. Any demolition of a structure to which IRC §280B and Treas. Reg. §1.280B-1 apply

**Information Required with Form 3115 for Changes Under §6.38.** A taxpayer making a change under this section must attach a description of the assets to which the change applies to their Form 3115. Depending on the change being made, the taxpayer must also include the following.

1. If the taxpayer makes a change in how assets are determined, a description of the assets for disposition purposes under the taxpayer’s present and proposed methods of accounting must be included.
2. If the taxpayer makes a change that involves identifying assets in a multiple-asset account, a description of the methods of identifying which assets have been disposed of under the taxpayer’s present and proposed methods of accounting must be included.
3. If the taxpayer makes a change that involves assets in the same multiple-asset account, a description of the methods of determining the unadjusted depreciable basis of the disposed asset or disposed portion of the asset, as applicable, must be included under the taxpayer’s present and proposed methods of accounting.
4. If the taxpayer makes a change that involves determining the unadjusted depreciable basis of the **disposed portion**<sup>94</sup> of an asset from an unreasonable method to a reasonable method, a description of the methods of determining the unadjusted depreciable basis of the disposed portion of the asset, as applicable, must be included under the taxpayer’s present and proposed methods of accounting.

<sup>91</sup> Rev. Proc. 2015-14, §6.38(1)(a).

<sup>92</sup> Treas. Reg. §1.1250-1(a)(2)(ii).

<sup>93</sup> Treas. Reg. §1.168(i)-8(d)(2).

<sup>94</sup> Treas. Reg. §1.168(i)-8(f)(3).

**IRC §481(a) Adjustment Period for Changes Under §6.38.** The following taxpayers must take the entire amount of the §481(a) adjustment into account in computing taxable income for the year of change, even if the adjustment is a positive amount.

- A taxpayer making a change in the method of determining which asset (or portion of an asset) has been disposed of if a gain or loss under Temp. Treas. Reg. §1.168(i)-8T has been recognized in a tax year before the year of change
- A taxpayer making a change from recognizing gain or loss under Temp. Treas. Reg. §1.168(i)-8T upon the disposition of an asset<sup>95</sup> included in a GAA to recognizing gain or loss upon the disposition of the same asset under the final Treas. Reg. §1.168(i)-8

All other taxpayers may claim a negative §481(a) adjustment in the year of change and spread a positive adjustment over four years.<sup>96</sup>

## **§6.39: Dispositions of Certain Tangible Depreciable Assets**

As mentioned previously, this set of changes is included within the automatic change procedures. All of these changes qualify for the simplified procedures under Rev. Proc. 2015-20. The designated automatic accounting method change number under this section is **206**.

Section 6.39 of Rev. Proc. 2015-14 covers the applicable rules to change the accounting method related to dispositions of the following assets.

- §1245 property
- Depreciable land improvements
- A portion of §1245 property or depreciable land improvements to which the **partial disposition rule** applies (Changes under this section may be made only by a taxpayer whose partial disposition was of the type **not requiring an election** on the original return.)

**Note.** For further details regarding partial dispositions that do not require an election, see the section “Partial Dispositions Election,” earlier in this chapter.

Changes under §6.39 affect the determination of gain or loss from disposing of these assets. It may also affect whether the taxpayer must capitalize amounts paid to restore a unit of property.

A taxpayer should make a change under this set of procedures if they want to change their method of identifying which assets or portions of assets have been disposed of or if they need to correct a partial disposition occurring in a prior year. A taxpayer should also use this set of procedures if they need to remove an asset from the depreciation schedule to claim a gain or loss that occurred in a prior year. Finally, a taxpayer should use this set of procedures to change how they determine the unadjusted basis of assets that have been disposed of. A complete list of changes that may be made under this procedure is provided in the appendix to this chapter.

<sup>95</sup> Treas. Reg. §1.168(i)-8(c)(4)(ii)(A), (B), or (D).

<sup>96</sup> Rev. Proc. 2015-14, §6.38(8)(b), referencing Rev. Proc. 2015-13, §7.03.

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This section does **not** apply to the following.

1. Any asset<sup>97</sup> that is not depreciated using MACRS under the taxpayer's present method of accounting and, if applicable, under the taxpayer's proposed method of accounting
2. Any building, condominium unit, or cooperative unit or any improvement or addition to such an asset, including any structural component (See §6.38 for changes related to buildings.)
3. Any asset subject to a GAA election<sup>98</sup> (See §6.37 for changes related to assets subject to the GAA election and §6.40 for changes related to disposing of assets subject to the GAA election.)
4. Any disposition of a portion of an asset for which a partial disposition election<sup>99</sup> is required but for which the taxpayer **did not make the election**

**Information Required with Form 3115 for Changes Under §6.39.** A taxpayer making a change under §6.39 of Rev. Proc. 2015-14 must attach a description of the assets to which the change applies to their Form 3115. Depending on the change being made, the taxpayer must also include the following.

1. If the taxpayer makes a change in how assets are determined, a description of the assets for disposition purposes under the taxpayer's present and proposed methods of accounting must be included.
2. If the taxpayer makes a change that involves identifying assets in a multiple-asset account, a description of the methods of identifying which assets have been disposed of under the taxpayer's present and proposed methods of accounting must be included.
3. If the taxpayer makes a change that involves assets in the same multiple-asset account, a description of the methods of determining the unadjusted depreciable basis of the disposed asset or disposed portion of the asset, as applicable, must be included under the taxpayer's present and proposed methods of accounting.
4. If the taxpayer makes a change that involves determining the unadjusted depreciable basis of the **disposed portion**<sup>100</sup> of an asset from an unreasonable method to a reasonable method, a description of the methods of determining the unadjusted depreciable basis of the disposed portion of the asset, as applicable, must be included under the taxpayer's present and proposed methods of accounting.

**Section 481(a) Adjustment Period for Changes Under §6.39.** The following taxpayers must take the entire amount of the §481(a) adjustment into account in computing taxable income for the year of change.

- A taxpayer making a change in the method of determining which asset or portion of an asset has been disposed of if that taxpayer recognized a gain or loss under Temp. Treas. Reg. §1.168(i)-8T on the disposition of the asset in a taxable year prior to the year of change
- A taxpayer making a change recognizing gain or loss under Temp. Treas. Reg. §1.168(i)-8T upon the disposition of an asset included in a GAA to recognizing gain or loss upon the disposition of the same asset under Treas. Reg. §1.168(i)-8

All other taxpayers may claim a negative §481(a) adjustment in the year of change and spread a positive adjustment over four years.

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<sup>97</sup> Treas. Reg. §1.168(i)-8(c)(4).

<sup>98</sup> IRC §168(i)(4) and the related regulations.

<sup>99</sup> Treas. Reg. §1.168(i)-8(d)(2).

<sup>100</sup> Treas. Reg. §1.168(i)-8(f)(3).

## §6.40: Dispositions of Tangible Depreciable Assets in a GAA

As mentioned previously, this set of changes is included within the automatic change procedures. None of these changes qualify for the simplified procedures under Rev. Proc. 2015-20. The designated automatic accounting method change number under this section is **207**.

Section 6.40 covers changes related to **disposing** of a depreciable asset subject to the GAA election.<sup>101</sup> Changes in these procedures may also affect the determination of gain or loss from the asset's disposal and may affect whether the taxpayer must capitalize amounts paid to restore a unit of property.<sup>102</sup>

A taxpayer should use the procedures in this section if they want to change how they determine which assets have been disposed of and the unadjusted depreciable basis of the assets. A complete list of covered changes is included in the appendix to this chapter.

This section does **not** apply to the following.

1. Any asset<sup>103</sup> that is **not** depreciated using MACRS under the taxpayer's present method of accounting and, if applicable, proposed method of accounting
2. Any asset **not** subject to a GAA election

**Information Required with Form 3115 for Changes Under §6.40.** A taxpayer making a change under this section must attach a description of the assets to which the change applies to their Form 3115. Depending on the change being made, the taxpayer must also include the following.

1. If the taxpayer makes a change in how assets are determined, a description of the assets for disposition purposes under the taxpayer's present and proposed methods of accounting must be included.
2. If the taxpayer makes a change involving identifying assets in a GAA, a description of the methods of identifying which assets have been disposed of under the taxpayer's present and proposed methods of accounting must be included.
3. If the taxpayer makes a change involving determining the unadjusted depreciable basis of the disposed asset or **disposed portion**<sup>104</sup> of an asset from an unreasonable method to a reasonable method, a description of the methods of determining the unadjusted depreciable basis of the disposed portion of the asset, as applicable, must be included under the taxpayer's present and proposed methods of accounting.

**Section 481(a) Adjustment Period for Changes Under §6.40.** When making a change listed in this section of Rev. Proc. 2015-14, most taxpayers may claim a negative §481(a) adjustment in the year of change and spread a positive adjustment over four years. However, the entire amount of a positive §481(a) adjustment is used in computing taxable income for the year of change if **both** the following conditions apply.

- The taxpayer makes a change in the method of determining which asset or portion of an asset has been disposed of
- The taxpayer previously filed Form 3115 and recognized a gain or loss under Temp. Treas. Regs. §1.168(i)-1T or §1.168(i)-8T on the disposition of the asset

<sup>101</sup>. IRC §168(i)(4) and the related regulations.

<sup>102</sup>. Temp. Treas. Reg. §1.263(a)-3T(e) or (f); Treas. Reg. §1.263(a)-3(e) or (f); Temp. Treas. Reg. §1.263(a)-3T(i); or Treas. Reg. §1.263(a)-3(k), as applicable.

<sup>103</sup>. Treas. Reg. §1.168(i)-1(e)(2)(viii).

<sup>104</sup>. Treas. Reg. §1.168(i)-8(f)(3).



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## §10.11: Certain Tangible Property Changes

As mentioned previously, this set of changes is included within the automatic change procedures. All of these changes qualify for the simplified procedures under Rev. Proc. 2015-20. In essence, §10.11 covers changes under the final tangible property regulations<sup>105</sup> that are not included elsewhere. The automatic accounting method designated change numbers (DCNs) are different for all the types of changes listed, as shown in the following table.

Description of Change	DCN	Treas. Reg. Citations
Change to deducting amounts paid or incurred for repair and maintenance or a change to capitalizing amounts paid or incurred for improvements to tangible property and, if depreciable, to depreciating such property under §§167 or 168. Includes a change, if any, in the <b>method of identifying the unit of property, or in the case of a building, identifying the building structure or building systems</b> for the purpose of making this change	184	§§1.162-4, 1.263(a)-3
Change to the regulatory accounting method	185	§1.263(a)-3(m)
Change to deducting nonincidental materials and supplies when used or consumed	186	§§1.162-3(a)(1), (c)(1)
Change to deducting incidental materials and supplies when paid or incurred	187	§§1.162-3(a)(2), (c)(1)
Change to deducting nonincidental rotatable and temporary spare parts when disposed of	188	§1.162-3(a)(3), (c)(2)
Change to the optional method for rotatable and temporary spare parts	189	§1.162-3(e)
Change by a dealer in property to deduct amounts paid for commissions	190	§1.263(a)-1(e)(2)
Change by a nondealer in property to capitalizing commissions and other costs that facilitate the sale of property	191	§1.263(a)-1(e)(1)
Change to capitalizing acquisition or production costs and, if depreciable, to depreciating such property under §167 or §168	192	§1.263(a)-2
Change to deducting certain costs for investigating or pursuing the acquisition of real property	193	§1.263(a)-2(f)(2)(iii)

<sup>105</sup>. Treas. Reg. §§1.162-3, 1.162-4, 1.263(a)-1, 1.263(a)-2, or 1.263(a)-3.



Section 10.11 does **not** apply to the following.

1. A taxpayer that wants to change their method of accounting for dispositions of depreciable property, including a change in the asset disposed of<sup>106</sup> (These are covered under §§6.38, 6.39, and 6.40)
2. Amounts paid or incurred for certain materials and supplies that the taxpayer has elected<sup>107</sup> to capitalize and depreciate
3. Amounts paid or incurred to which the taxpayer has elected<sup>108</sup> to apply the de minimis safe harbor
4. Amounts paid or incurred for employee compensation or overhead that the taxpayer has elected<sup>109</sup> to capitalize
5. Amounts paid or incurred to which the taxpayer has elected<sup>110</sup> to apply the safe harbor for small taxpayers
6. Amounts paid or incurred for repair and maintenance costs that the taxpayer has elected<sup>111</sup> to capitalize
7. Amounts paid or incurred to facilitate the acquisition or disposition of assets that constitute a trade or business<sup>112</sup>

**Information Required with Form 3115 for Changes Under §10.11.** In addition to the other information required on line 14 of Form 3115, the taxpayer must include the following.

1. The taxpayer must include a citation to the paragraph of the regulations that provides for the proposed method(s) of accounting to which the taxpayer is changing.
2. If the taxpayer changes any unit(s) of property<sup>113</sup> or the identification of any building structure(s) or building system(s)<sup>114</sup> for purposes of determining whether amounts are deducted as repair and maintenance costs<sup>115</sup> or capitalized as improvement costs,<sup>116</sup> they must include:
  - a. A detailed description of the unit(s) of property, building structure(s), or building system(s) used under its present method of accounting;
  - b. A detailed description of the unit(s) of property, building structure(s), or building system(s) under its proposed method of accounting; and
  - c. A citation to the paragraph of the final regulation or temporary regulation under which the change in identifying the unit of property, building structure, or building system is permitted.
3. A taxpayer changing their method of accounting to capitalize amounts paid or incurred and to depreciate assets must complete Schedule E of Form 3115. (See **Example 14** for a sample Schedule E.)

<sup>106</sup> See Rev. Proc. 2015-14, §§6.29, 6.30, 6.31, 6.33, 6.34, and 6.35, for the procedures that may be used for dispositions.

<sup>107</sup> Treas. Reg. §1.162-3(d).

<sup>108</sup> Treas. Reg. §1.263(a)-1(f).

<sup>109</sup> Treas. Reg. §1.263(a)-2(f)(2)(iv)(B).

<sup>110</sup> Treas. Reg. §1.263(a)-3(h).

<sup>111</sup> Treas. Reg. §1.263(a)-3(n).

<sup>112</sup> See Rev. Proc. 2015-14, §10.05, for procedures to make changes related to these transactions.

<sup>113</sup> Treas. Reg. §1.263(a)-3(e) (or Temp. Treas. Reg. §1.263(a)-3T(e)).

<sup>114</sup> Treas. Reg. §1.263-3(e)(2) (or Temp. Treas. Reg. §1.263-3T(e)(2)).

<sup>115</sup> Treas. Reg. §1.162-4 (or Temp. Treas. Reg. §1.162-4T).

<sup>116</sup> Treas. Reg. §1.263(a)-3 (or Temp. Treas. Reg. §1.263(a)-3T).

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4. A taxpayer changing to a method of accounting in this section must include on part IV, line 26, the §481(a) adjustment for **each change** in method of accounting being made. If the taxpayer makes more than one change in method of accounting under the final tangible property regulations, they (including a qualified small taxpayer) must provide the following on an **attachment** to Form 3115.
  - a. The information required by part IV, line 26, for each change in accounting method (including the amount of the §481(a) adjustment for each change in accounting method)
  - b. The information required by part II, line 14, for each change
  - c. A citation to the paragraph of the final tangible property regulations or temporary tangible property regulations that applies to each proposed method of accounting

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<b>Part II Information for All Requests</b> (continued)		<b>Yes</b>	<b>No</b>
<b>14</b>	If the applicant is either <b>(i) not</b> changing its overall method of accounting, or <b>(ii)</b> changing its overall method of accounting <b>and</b> changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following (see instructions):		
<b>a</b>	The item(s) being changed.		
<b>b</b>	The applicant's present method for the item(s) being changed.		
<b>c</b>	The applicant's proposed method for the item(s) being changed.		
<b>d</b>	The applicant's present overall method of accounting (cash, accrual, or hybrid).		
	Attach a detailed and complete description of the applicant's trade(s) or business(es).		

**Section 481(a) Adjustment Under §10.11.** Most taxpayers changing to a method of accounting under §10.11 of Rev. Proc. 2015-14 may claim a negative §481(a) adjustment in the year of change and spread a positive adjustment over four years.<sup>117</sup> However, the adjustment is limited for certain changes.

For changes to a method of accounting under the following regulations, the §481(a) adjustment **includes only amounts paid or incurred in tax years beginning on or after January 1, 2014.** (Alternatively, a taxpayer may take into account amounts paid or incurred in tax years beginning on or after January 1, 2012.)

- Treas. Reg. §1.162-3 (not including §1.162-3(e)) for accounting procedures regarding materials and supplies except the optional method of accounting for rotatable and temporary spare parts
- Treas. Reg. §1.263(a)-2(f)(2)(iii) regarding costs to facilitate the acquisition of real property and allocating those costs to personal property acquired at the same time
- Treas. Reg. §1.263(a)-2(f)(3)(ii) relating to inherently facilitative amounts allocable to the purchase of real or personal property when the property is ultimately not purchased
- Treas. Reg. §1.263(a)-3(m) for adopting the optional regulatory accounting method to determine whether amounts paid to repair, maintain, or improve tangible property are treated as deductible expenses or capital expenditures
- Treas. Reg. §1.263A-1(e)(2)(i)(A) requiring manufacturers to capitalize direct material costs that become an integral part of specific property produced when those materials are consumed in the ordinary course of production and the materials can be identified or associated with particular units or groups of units of property produced
- Treas. Reg. §1.263A-1(e)(3)(ii)(E) requiring manufacturers to capitalize indirect materials costs when those materials are consumed in the ordinary course of production and **cannot** be identified or associated with particular units or groups of units of property produced

<sup>117</sup> Rev. Proc. 2015-14, §6.40(6)(b), referencing Rev. Proc. 2015-13, §7.03.

If the taxpayer previously elected to use the repair allowance under Treas. Reg. §1.167(a)-11(d)(2) (which has been repealed), the amount included in the election cannot be included in the §481(a) adjustment. This applies when the taxpayer changes to a method of accounting provided by Treas. Reg. §1.263(a)-3 for improvements to tangible property.

**Example 14.** Beastly Apparel Inc. (Beastly) is a calendar-year taxpayer. Beastly acquired and placed in service a building and its structural components on July 1, 2001. This property's basis was \$150,000 — with \$15,000 (10% of the total cost) attributable to the land and the remaining \$135,000 attributable to the building. The building was capitalized as one asset for depreciation purposes.

In 2012, Beastly replaced the building's roof at a cost of \$40,000. It claimed this \$40,000 as a repair on its 2012 tax return. The company did **not** recognize a loss on the retirement of the original roof and continued to depreciate the original roof.

The IRS examined Beastly's 2012 return. Upon examination, the IRS disallowed the \$40,000 repair deduction and required that it be capitalized instead.

Beastly's CPA, Kyle, recommends that the company file Form 3115 with its 2015 corporate income tax return. The Form 3115 will facilitate a deduction of the remaining loss from the roof that was replaced. Because the IRS capitalized the \$40,000 repair cost,<sup>118</sup> a change by the company from depreciating the original roof to recognizing a loss upon its retirement is covered under Rev. Proc. 2015-14, §6.38.

The original building and its components were not accounted for separately for depreciation purposes. Accordingly, the cost of the original roof must be separated from the cost of the entire building using any reasonable method.<sup>119</sup>

Kyle notes that the FMV of the real estate at the time the roof was replaced in 2012 was \$300,000. Because 10% of the original property's purchase price in 2001 was allocated to the land, Kyle allocates 10% of the 2012 FMV of the entire property to the land. Therefore, of the \$300,000 FMV, \$30,000 is allocated to the land. The remaining \$270,000 is the FMV attributable to the building and components.

Kyle consults an insurance adjuster who tells him that in their area of the country, the replacement cost is usually 150% of the FMV. Kyle uses that estimate to determine that the replacement cost of the entire building would have been \$405,000 (\$270,000 × 150%). Because it cost \$40,000 to replace the roof, Kyle determines that 9.88% (\$40,000 ÷ \$405,000) of the original cost of the building was attributable to the original roof.

As of December 31, 2014, the basis of the building and the accumulated depreciation were \$135,000 and \$46,587, respectively. Kyle allocates these amounts as follows.

	Building	Accumulated Depreciation	Adjusted Basis
Balance on 12/31/14	\$135,000	\$46,587	\$88,413
	\$135,000	\$46,587	\$88,413
Percent allocated to roof	× 9.88%	× 9.88%	× 9.88%
Amount attributed to roof	\$ 13,338	\$ 4,603	\$ 8,735
Amount attributed to remaining building	\$121,662	\$41,984	\$79,678

Next, Kyle determines whether Beastly's average annual gross receipts exceed \$10 million. Based on his review of Beastly's 2012–2014 tax returns, Kyle determines that Beastly's average annual gross receipts are \$2 million. Accordingly, Beastly qualifies to only complete selected sections of Form 3115 to request a change in accounting procedures under Rev. Proc. 2015-14, §6.38. Kyle completes only the required parts and lines of Form 3115. (See the table earlier in this section for the required parts and lines under Rev. Proc. 2015-14.)

<sup>118</sup>. Treas. Reg. §1.168(i)-8(d)(2)(iii).

<sup>119</sup>. Treas. Reg. §1.168(i)-8(f).

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## For Example 14

Form <b>3115</b> (Rev. December 2015) Department of the Treasury Internal Revenue Service	<b>Application for Change in Accounting Method</b>  ► Information about Form 3115 and its separate instructions is at <a href="http://www.irs.gov/form3115">www.irs.gov/form3115</a> .	OMB No. 1545-0152				
Name of filer (name of parent corporation if a consolidated group) (see instructions) <b>Beastly Apparel, Inc.</b>		Identification number (see instructions) <b>37-3115001</b>				
Number, street, and room or suite no. If a P.O. box, see the instructions. <b>1 Castle Court</b>		Principal business activity code number (see instructions) <b>448140 (Family Clothing Store)</b>				
City or town, state, and ZIP code <b>Downsville, LA 71234</b>		Tax year of change begins (MM/DD/YYYY) <b>01/01/2015</b> Tax year of change ends (MM/DD/YYYY) <b>12/31/2015</b>				
Name of applicant(s) (if different than filer) and identification number(s) (see instructions)		Name of contact person (see instructions) <b>Kyle Kingly</b>				
Contact person's telephone number <b>(225) 555-3115</b>						
If the applicant is a member of a consolidated group, check this box. <input type="checkbox"/>						
If <b>Form 2848</b> , Power of Attorney and Declaration of Representative, is attached (see instructions for when Form 2848 is required), check this box. <input checked="" type="checkbox"/>						
<b>Check the box to indicate the type of applicant.</b>						
<input type="checkbox"/> Individual <input type="checkbox"/> Cooperative (Sec. 1381) <input checked="" type="checkbox"/> Corporation <input type="checkbox"/> Partnership <input type="checkbox"/> Controlled foreign corporation (Sec. 957) <input type="checkbox"/> S corporation <input type="checkbox"/> 10/50 corporation (Sec. 904(d)(2)(E)) <input type="checkbox"/> Insurance co. (Sec. 816(a)) <input type="checkbox"/> Qualified personal service corporation (Sec. 448(d)(2)) <input type="checkbox"/> Insurance co. (Sec. 831) <input type="checkbox"/> Exempt organization. Enter Code section ►						
<b>Check the appropriate box to indicate the type of accounting method change being requested.</b> See instructions. <input type="checkbox"/> Depreciation or Amortization <input type="checkbox"/> Financial Products and/or Financial Activities of Financial Institutions <input checked="" type="checkbox"/> Other (specify) ► <b>Partial Disposition</b>						
<b>Caution:</b> To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer or to the taxpayer's requested change in method of accounting. This includes (1) all relevant information requested on this Form 3115 (including its instructions), and (2) any other relevant information, even if not specifically requested on Form 3115. <b>The taxpayer must attach all applicable statements requested throughout this form.</b>						
<b>Part I Information for Automatic Change Request</b>						
1 Enter the applicable designated automatic accounting method change number ("DCN") for the requested automatic change. Enter only one DCN, except as provided for in guidance published by the IRS. If the requested change has no DCN, check "Other," and provide both a description of the change and a citation of the IRS guidance providing the automatic change. See instructions.		<table border="1" style="width: 100%;"> <tr> <th style="width: 50%;">Yes</th> <th style="width: 50%;">No</th> </tr> <tr> <td></td> <td></td> </tr> </table>	Yes	No		
Yes	No					
a (1) DCN: <b>205</b> (2) DCN: (3) DCN: (4) DCN: (5) DCN: (6) DCN: (7) DCN: (8) DCN: (9) DCN: (10) DCN: (11) DCN: (12) DCN:						
b Other <input type="checkbox"/> Description ►						
2 Do any of the eligibility rules restrict the applicant from filing the requested change using the automatic change procedures (see instructions)? If "Yes," attach an explanation.		<table border="1" style="width: 100%;"> <tr> <th style="width: 50%;">Yes</th> <th style="width: 50%;">No</th> </tr> <tr> <td></td> <td style="text-align: center;">x</td> </tr> </table>	Yes	No		x
Yes	No					
	x					
3 Has the filer provided all the information and statements required (a) on this form and (b) by the List of Automatic Changes under which the applicant is requesting a change? See instructions. <b>Note:</b> Complete Part II and Part IV of this form, and, Schedules A through E, if applicable.		<table border="1" style="width: 100%;"> <tr> <th style="width: 50%;">Yes</th> <th style="width: 50%;">No</th> </tr> <tr> <td style="text-align: center;">x</td> <td></td> </tr> </table>	Yes	No	x	
Yes	No					
x						
<b>Part II Information for All Requests</b>						
4 During the tax year of change, did or will the applicant (a) cease to engage in the trade or business to which the requested change relates, or (b) terminate its existence? See instructions.		<table border="1" style="width: 100%;"> <tr> <th style="width: 50%;">Yes</th> <th style="width: 50%;">No</th> </tr> <tr> <td></td> <td style="text-align: center;">x</td> </tr> </table>	Yes	No		x
Yes	No					
	x					
5 Is the applicant requesting to change to the principal method in the tax year of change under section 1.381(c)(4)-1(d)(1) or 1.381(c)(5)-1(d)(1)? If "No," go to line 6a. If "Yes," the applicant cannot file a Form 3115 for this change. See instructions.		<table border="1" style="width: 100%;"> <tr> <th style="width: 50%;">Yes</th> <th style="width: 50%;">No</th> </tr> <tr> <td></td> <td style="text-align: center;">x</td> </tr> </table>	Yes	No		x
Yes	No					
	x					
<b>Sign Here</b>	Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge. Signature of filer (and spouse, if joint return) _____ Date _____ Name and title (print or type) <b>Robby Benson</b>					
<b>Preparer (other than filer/applicant)</b>	Print/Type preparer's name <b>Kyle Kingly</b> Preparer's signature _____ Date _____ Firm's name ►					

For Privacy Act and Paperwork Reduction Act Notice, see the instructions.

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## For Example 14

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<b>Part II Information for All Requests</b> (continued)		Yes	No
<b>6a</b>	Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any federal income tax return(s) under examination (see instructions)? . . . . . If "No," go to line 7a.		<b>x</b>
<b>b</b>	Is the method of accounting the applicant is requesting to change an issue under consideration (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s))? See instructions. . . . .		
<b>c</b>	Enter the name and telephone number of the examining agent and the tax year(s) under examination. Name ▶ _____ Telephone number ▶ _____ Tax year(s) ▶ _____		
<b>d</b>	Has a copy of this Form 3115 been provided to the examining agent identified on line 6c? . . . . .		
<b>7a</b>	Does audit protection apply to the applicant's requested change in method of accounting? See instructions. . . . . If "No," attach an explanation.	<b>x</b>	
<b>b</b>	If "Yes," check the applicable box and attach the required statement. <input type="checkbox"/> Not under exam <input type="checkbox"/> 3-month window <input type="checkbox"/> 120 day: Date examination ended ▶ _____ <input type="checkbox"/> Method not before director <input type="checkbox"/> Negative adjustment <input type="checkbox"/> CAP: Date member joined group ▶ _____ <input type="checkbox"/> Audit protection at end of exam <input type="checkbox"/> Other		
<b>8a</b>	Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any federal income tax return(s) before Appeals and/or a federal court? . . . . . If "No," go to line 9.		<b>x</b>
<b>b</b>	Is the method of accounting the applicant is requesting to change an issue under consideration by Appeals and/or a federal court (for either the applicant or any present or former consolidated group in which the applicant was a member for the tax year(s) the applicant was a member)? See instructions. . . . . If "Yes," attach an explanation.		
<b>c</b>	If "Yes," enter the name of the (check the box) <input type="checkbox"/> Appeals officer and/or <input type="checkbox"/> counsel for the government, telephone number, and the tax year(s) before Appeals and/or a federal court. Name ▶ _____ Telephone number ▶ _____ Tax year(s) ▶ _____		
<b>d</b>	Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 8c? . . . . .		
<b>9</b>	If the applicant answered "Yes" to line 6a and/or 8a with respect to any present or former consolidated group, attach a statement that provides each parent corporation's (a) name, (b) identification number, (c) address, and (d) tax year(s) during which the applicant was a member that is under examination, before an Appeals office, and/or before a federal court.		
<b>10</b>	If for federal income tax purposes, the applicant is either an entity (including a limited liability company) treated as a partnership or an S corporation, is it requesting a change from a method of accounting that is an issue under consideration in an examination, before Appeals, or before a federal court, with respect to a federal income tax return of a partner, member, or shareholder of that entity? . . . . .		<b>x</b>
<b>11a</b>	Has the applicant, its predecessor, or a related party requested or made (under either an automatic or non-automatic change procedure) a change in method of accounting within any of the five tax years ending with the tax year of change? . . . . . If "No," go to line 12.		<b>x</b>
<b>b</b>	If "Yes," for each trade or business, attach a description of each requested change in method of accounting (including the tax year of change) and state whether the applicant received consent.		
<b>c</b>	If any application was withdrawn, not perfected, or denied, or if a Consent Agreement granting a change was not signed and returned to the IRS, or the change was not made or not made in the requested year of change, attach an explanation.		
<b>12</b>	Does the applicant, its predecessor, or a related party currently have pending any request (including any concurrently filed request) for a private letter ruling, change in method of accounting, or technical advice? . . . . . If "Yes," for each request attach a statement providing (a) the name(s) of the taxpayer, (b) identification number(s), (c) the type of request (private letter ruling, change in method of accounting, or technical advice), and (d) the specific issue(s) in the request(s).		<b>x</b>
<b>13</b>	Is the applicant requesting to change its <b>overall</b> method of accounting? . . . . . If "Yes," complete Schedule A on page 4 of the form.		

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## For Example 14

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<b>Part II Information for All Requests (continued)</b>		<b>Yes</b>	<b>No</b>						
<b>14</b>	If the applicant is either <b>(i) not</b> changing its overall method of accounting, or <b>(ii)</b> changing its overall method of accounting <b>and</b> changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following (see instructions):								
<b>a</b>	The item(s) being changed.								
<b>b</b>	The applicant's present method for the item(s) being changed.								
<b>c</b>	The applicant's proposed method for the item(s) being changed.								
<b>d</b>	The applicant's present overall method of accounting (cash, accrual, or hybrid).								
<b>15a</b>	Attach a detailed and complete description of the applicant's trade(s) or business(es).								
<b>b</b>	If the applicant has more than one trade or business, as defined in Regulations section 1.446-1(d), describe <b>(i)</b> whether each trade or business is accounted for separately; <b>(ii)</b> the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; <b>(iii)</b> the overall method of accounting for each trade or business; and <b>(iv)</b> which trade or business is requesting to change its accounting method as part of this application or a separate application.								
<b>16a</b>	Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explains how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method.								
<b>b</b>	Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method.								
<b>c</b>	Include either a discussion of the contrary authorities or a statement that no contrary authority exists.								
<b>17</b>	Will the proposed method of accounting be used for the applicant's books and records and financial statements? For insurance companies, see the instructions. . . . . If "No," attach an explanation.								
<b>18</b>	Does the applicant request a conference with the IRS National Office if the IRS National Office proposes an adverse response?		<b>x</b>						
<b>19a</b>	If the applicant is changing to either the overall cash method, an overall accrual method, or is changing its method of accounting for any property subject to section 263A, any long-term contract subject to section 460 (see 19b), or inventories subject to section 474, enter the applicant's gross receipts for the 3 tax years preceding the tax year of change.								
	<table border="1"> <tr> <td>1st preceding year ended: mo. yr.</td> <td>2nd preceding year ended: mo. yr.</td> <td>3rd preceding year ended: mo. yr.</td> </tr> <tr> <td>\$</td> <td>\$</td> <td>\$</td> </tr> </table>	1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.	\$	\$	\$		
1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.							
\$	\$	\$							
<b>b</b>	If the applicant is changing its method of accounting for any long-term contract subject to section 460, in addition to completing 19a, enter the applicant's gross receipts for the 4th tax year preceding the tax year of change: 4th preceding year ended: mo. yr. \$								
<b>Part III Information for Non-Automatic Change Request</b>		<b>Yes</b>	<b>No</b>						
<b>20</b>	Is the applicant's requested change described in any revenue procedure, revenue ruling, notice, regulation, or other published guidance as an automatic change request? . . . . . If "Yes," attach an explanation describing why the applicant is submitting its request under the non-automatic change procedures.								
<b>21</b>	Attach a copy of all documents related to the proposed change (see instructions).								
<b>22</b>	Attach a statement of the applicant's reasons for the proposed change.								
<b>23</b>	If the applicant is a member of a consolidated group for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed? . . . . . If "No," attach an explanation.								
<b>24a</b>	Enter the amount of <b>user fee</b> attached to this application (see instructions). ► \$								
<b>b</b>	If the applicant qualifies for a reduced user fee, attach the required information or certification (see instructions).								

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## For Example 14

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Part IV Section 481(a) Adjustment		Yes	No
25	Does published guidance require the applicant (or permit the applicant and the applicant is electing) to implement the requested change in method of accounting on a cut-off basis? . . . . . If "Yes," attach an explanation and do not complete lines 26, 27, and 28 below.		
26	Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ \$ <b>(8,735)</b> Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the application, attach a list of the (a) name, (b) identification number, and (c) the amount of the section 481(a) adjustment attributable to each applicant.		
27	Is the applicant making an election to take the entire amount of the adjustment into account in the tax year of change? If "Yes," check the box for the applicable elective provision used to make the election (see instructions). <input type="checkbox"/> \$50,000 de minimis election <input type="checkbox"/> Eligible acquisition transaction election		
28	Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties? . . . . . If "Yes," attach an explanation.		

**5**

11 Other costs

### Schedule E—Change in Depreciation or Amortization. See instructions.

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Applicants **must** provide this information for each item or class of property for which a change is requested.

**Note:** See the **Summary of the List of Automatic Accounting Method Changes** in the instructions for information regarding automatic changes under sections 56, 167, 168, 197, 1400I, 1400L, or former section 168. **Do not** file Form 3115 with respect to certain late elections and election revocations. See instructions.

- Is depreciation for the property determined under Regulations section 1.167(a)-11 (CLADR)? . . . . ☐ Yes ☐ No  
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).
- Is any of the depreciation or amortization required to be capitalized under any Code section such as, section 263A? . . . . ☐ Yes ☐ No  
If "Yes," enter the applicable section ▶
- Has a depreciation, amortization, expense, or disposition election been made for the property such as, the election under sections 168(f)(1), 168(i)(4), 179, 179C, or Regulations section 1.168(i)-8(d)? . . . . ☐ Yes ☒ No  
If "Yes," state the election made ▶
- a To the extent not already provided, attach a statement describing the property subject to the change. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.  
b If the property is residential rental property, did the applicant live in the property before renting it? . . . ☐ Yes ☐ No  
c Is the property public utility property? . . . . ☐ Yes ☐ No
- To the extent not already provided in the applicant's description of its present method, attach a statement explaining how the property is treated under the applicant's present method (for example, depreciable property, inventory property, supplies, nondepreciable section 1.162-3, nondepreciable section 263A property, property deductible as expense, etc.)



# 2015 Workbook

## For Example 14

Beastly Apparel, Inc.

FEIN: 37-3115001

### Form 3115 Attachment

#### Information required by Rev. Proc. 2015-14

The taxpayer is changing its method of identifying property disposed of in a prior year. Under the prior method, the roof was capitalized as part of the building and was not separately stated. The IRS has examined the 2012 income tax return of the taxpayer and determined that the roof was replaced in that year. The IRS examination resulted in the capitalization of the roof replacement.

Under the proposed method of accounting, the taxpayer is separating the original cost basis of the replaced roof and claiming a loss on its disposition. For the proposed change, the unadjusted basis of the roof at the time the building was purchased has been determined using the cost to replace the roof as a percentage of the estimated replacement cost of the entire building.

#### Part II, line 14

- a. The taxpayer claims a loss on the remaining adjusted basis of the roof component of the building as of December 31, 2014, for the roof that was replaced in 2012.
- b. Depreciation of the replaced roof was continued after it was disposed of.
- c. The remaining adjusted basis will be claimed as a loss using the §481(a) adjustment.
- d. The taxpayer uses the cash method of accounting.

#### Part IV, line 26

The total §481(a) adjustment for this change is  $-\$8,735$ . This represents the remaining basis of the disposed roof as of December 31, 2014.

The original unadjusted basis of the commercial building and its components was \$135,000 when the building was placed into service on July 1, 2001. The building has been depreciated using the midmonth convention on the straight-line basis with a 39-year life.

As of December 31, 2014, the basis of the building and the accumulated depreciation were \$135,000 and \$46,587, respectively. These were allocated based on the assumption that the original cost of the roof was 9.88% of the cost of the building as a whole. This percentage was calculated based on a replacement cost of \$40,000 for the roof and an estimated replacement cost for the entire building of \$405,000 at the time the roof was replaced in 2012.

	Building	Accumulated Depreciation	Adjusted Basis
Balance on 12/31/14	\$135,000	\$46,587	\$88,413
Percent allocated to roof	$\times 9.88\%$	$\times 9.88\%$	$\times 9.88\%$
Amount attributed to roof	\$ 13,338	\$ 4,603	\$ 8,735

## APPENDIX

### AUTOMATIC CHANGES FOR DISPOSITIONS OF TANGIBLE PROPERTY<sup>120</sup>

The following table summarizes the changes in accounting methods that a taxpayer may make under Rev. Proc. 2015-14.

Final Regulation Section	Section in Rev. Proc. 2015-14	DCN
§1.167(a)-4, Depreciation of leasehold improvements	6.36	199
<b>GAAs</b>		
§1.168(i)-1(c), Change in grouping assets	6.37	200
§1.168(i)-1(e)(2)(viii), Change in determining asset disposed of	6.40	207
§1.168(i)-1(j)(2), Change in method of identifying which assets or portions of assets have been disposed of from one method to another method specified in §1.168(i)-1(j)(2)	6.37	200
§1.168(i)-1(j)(2), Change in method of identifying which assets or portions of assets have been disposed of from a method not specified in §1.168(i)-1(j)(2) to a method specified in §1.168(i)-1(j)(2)	6.40	207
§1.168(i)-1(j)(3), Change in determining unadjusted depreciable basis of disposed asset or disposed portion of an asset from one reasonable method to another reasonable method when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of disposed asset or disposed portion of asset	6.37	200
§1.168(i)-1(j)(3), Change in determining unadjusted depreciable basis of disposed asset or disposed portion of an asset from not using to using the taxpayer's records when it is practicable from the taxpayer's records to determine the unadjusted depreciable basis of disposed asset or disposed portion of asset	6.40	207
§1.168(i)-1(j)(3), Change in determining unadjusted depreciable basis of disposed asset or disposed portion of an asset from an unreasonable method to a reasonable method when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of disposed asset or disposed portion of asset	6.40	207
<b>Single-Asset Accounts or Multiple Asset Accounts for MACRS Property</b>		
§1.168(i)-7, Change from single-asset accounts to multiple-asset accounts, or vice versa	6.37	200
§1.168(i)-7(c), Change in grouping assets in multiple-asset accounts	6.37	200

<sup>120</sup> Rev. Proc. 2015-14, §6.41.

# 2015 Workbook

Final Regulation Section	Section in Rev. Proc. 2015-14	DCN
<b>Dispositions of MACRS Property (not in GAAs)</b>		
§1.168(i)-8(c)(4), Change in determining asset disposed of	6.38 (Building or structural component)	205
	6.39 (Property other than a building or structural component)	206
§1.168(i)-8(f)(2) or (3), Change in determining unadjusted depreciable basis of disposed asset in a multiple-asset account or disposed portion of an asset from one reasonable method to another reasonable method when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of disposed asset or disposed portion of asset	6.37	200
§1.168(i)-8(f)(2) or (3), Change in determining unadjusted depreciable basis of disposed asset in a multiple-asset account or disposed portion of an asset from not using to using the taxpayer's records when it is practicable from the taxpayer's records to determine the unadjusted depreciable basis of disposed asset or disposed portion of asset	6.38 (Building or structural component)	205
	6.39 (Property other than a building or structural component)	206
§1.168(i)-8(f)(2) or (3), Change in determining unadjusted depreciable basis of disposed asset in a multiple-asset account or disposed portion of an asset from an unreasonable method to a reasonable method when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of disposed asset or disposed portion of asset	6.38 (Building or structural component)	205
	6.39 (Property other than a building or structural component)	206
§1.168(i)-8(g), Change in method of identifying which assets in a multiple-asset account or portions of assets have been disposed of from one method to another method specified in §1.168(i)-8(g)(1) or (2)	6.37	200
§1.168(i)-8(g), Change in method of identifying which assets in a multiple-asset account or portions of assets have been disposed of from a method not specified in §1.168(i)-8(g)(1) or (2) to a method specified in §1.168(i)-8(g)(1) or (2)	6.38 (Building or structural component)	205
	6.39 (Property other than a building or structural component)	206
§1.168(i)-8(h)(1), Change from depreciating a disposed asset or disposed portion of an asset to recognizing gain or loss upon disposition when a taxpayer continues to depreciate the asset or portion that they disposed of prior to the year of change	6.38 (Building or structural component)	205
	6.39 (Property other than a building or structural component)	206
§1.168(i)-8(d)(2)(iii), Partial disposition election for the disposition of a portion of an asset to which the IRS's adjustment pertains	6.35	198

## SPECIFIC AUTOMATIC CHANGES FROM REV. PROC. 2015-14

### §6.37: Permissible to Permissible Method for Depreciation of Pooled Assets or GAAs

The following changes allowed under §6.37 are for items of MACRS property that are not subject to a GAA election and that qualify under the simplified procedures for small business taxpayers.<sup>121</sup>

1. A change in the method of identifying which assets in multiple-asset accounts or which portions of assets have been disposed of by the taxpayer from the FIFO method of accounting<sup>122</sup> or the modified FIFO method of accounting<sup>123</sup> to the specific identification method<sup>124</sup> (using a §481(a) adjustment)
2. A change in the method of identifying which assets in multiple-asset accounts or which portions of assets have been disposed of by the taxpayer from the FIFO method of accounting<sup>125</sup> to the modified FIFO method of accounting<sup>126</sup> or vice versa (using a §481(a) adjustment)
3. A change in the method of identifying which mass assets<sup>127</sup> in multiple-asset accounts or which portions of mass assets have been disposed of by the taxpayer from the FIFO method of accounting<sup>128</sup> or the modified FIFO method of accounting<sup>129</sup> to a mortality dispersion table<sup>130</sup> (using a §481(a) adjustment)
4. A change in the method of identifying which mass assets<sup>131</sup> in multiple-asset accounts or which portions of mass assets have been disposed of by the taxpayer from a mortality dispersion table<sup>132</sup> to the specific identification method,<sup>133</sup> the FIFO method of accounting,<sup>134</sup> or the modified FIFO method of accounting<sup>135</sup> (using a §481(a) adjustment)

<sup>121</sup>. See IRC §168(i)(4) and related regulations.

<sup>122</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(i).

<sup>123</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(ii).

<sup>124</sup>. Under Treas. Reg. §1.168(i)-8(g)(1).

<sup>125</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(i).

<sup>126</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(ii).

<sup>127</sup>. As defined in Treas. Reg. §1.168(i)-8(b)(3).

<sup>128</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(i).

<sup>129</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(ii).

<sup>130</sup>. In accordance with Treas. Reg. §1.168(i)-8(g)(2)(iii).

<sup>131</sup>. As defined in Treas. Reg. §1.168(i)-8(b)(3).

<sup>132</sup>. In accordance with Treas. Reg. §1.168(i)-8(g)(2)(iii).

<sup>133</sup>. Under Treas. Reg. §1.168(i)-8(g)(1).

<sup>134</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(i).

<sup>135</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(ii).

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The following changes allowed under §6.37 are for items of MACRS property that are **not** subject to a GAA election but **do not** qualify under the simplified procedures.

1. A change<sup>136</sup> from single-asset accounts (or item accounts) for specific items of MACRS property to multiple-asset accounts (or pools) for the same assets or vice versa (using the modified cut-off method)
2. A change<sup>137</sup> from grouping specific items of MACRS property in multiple-asset accounts to a different grouping of the same assets in multiple-asset accounts (using the modified cut-off method)
3. A change in the method of identifying which assets in multiple-asset accounts or which portions of assets have been disposed of by the taxpayer from the specific identification method<sup>138</sup> to the FIFO method<sup>139</sup> or the modified FIFO method<sup>140</sup> (using a cut-off method and applying to dispositions occurring on or after the beginning of the year of change)
4. A change in the method of identifying which mass assets<sup>141</sup> in multiple-asset accounts or which portions of mass assets have been disposed of by the taxpayer from the specific identification method<sup>142</sup> to a mortality dispersion table<sup>143</sup> (using a cut-off method and applying to dispositions occurring on or after the beginning of the year of change)
5. For disposition of an asset in a multiple-asset account<sup>144</sup> when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the asset disposed of, a change in the method of determining the unadjusted depreciable basis of all assets in the same multiple-asset account from one reasonable method to another reasonable method (using a cut-off method and applying to dispositions occurring on or after the beginning of the year of change)
6. For disposition of a portion of an asset<sup>145</sup> when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed portion of the asset, a change in the method of determining the unadjusted depreciable basis of all disposed portions of the asset from one reasonable method to another reasonable method (using a cut-off method and applying to dispositions occurring on or after the beginning of the year of change)

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<sup>136</sup>. Under Treas. Reg. §1.168(i)-7.

<sup>137</sup>. Under Treas. Reg. §1.168(i)-7(c).

<sup>138</sup>. Under Treas. Reg. §1.168(i)-8(g)(1).

<sup>139</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(i).

<sup>140</sup>. Under Treas. Reg. §1.168(i)-8(g)(2)(ii).

<sup>141</sup>. As defined in Treas. Reg. §1.168(i)-8(b)(3).

<sup>142</sup>. Under Treas. Reg. §1.168(i)-8(g)(1).

<sup>143</sup>. In accordance with Treas. Reg. §1.168(i)-8(g)(2)(iii).

<sup>144</sup>. Under Treas. Reg. §1.168(i)-8(f)(2).

<sup>145</sup>. Under Treas. Reg. §1.168(i)-8(f)(3).

The following changes allowed under this provision are for the items of MACRS property that **are subject** to a GAA election.<sup>146</sup>

1. A change from grouping specific items of MACRS property in GAAs to a different grouping of the same assets in GAAs<sup>147</sup> (using the modified cut-off method, defined earlier)
2. A change in the method of identifying which assets or which portions of assets have been disposed of by the taxpayer from the specific identification method<sup>148</sup> to the FIFO method<sup>149</sup> or the modified FIFO method<sup>150</sup> (using a cut-off method and applying to dispositions occurring on or after the beginning of the year of change)
3. A change in the method of identifying which assets or which portions of assets have been disposed of by the taxpayer from the FIFO method of accounting<sup>151</sup> or the modified FIFO method of accounting<sup>152</sup> to the specific identification method<sup>153</sup> (using a §481(a) adjustment, but the §481(a) adjustment should be zero unless the special rules for terminating GAAs<sup>154</sup> apply to the asset subject to the change (See IRS Pub. 946, *How to Depreciate Property*, for more information about terminating a GAA election.)
4. A change in the method of identifying which assets or which portions of assets have been disposed of by the taxpayer from the FIFO method<sup>155</sup> to the modified FIFO<sup>156</sup> or vice versa (using a §481(a) adjustment, but the §481(a) adjustment should be zero unless the special rules for terminating GAAs<sup>157</sup> apply to the asset subject to the change)
5. A change in the method of identifying which mass assets<sup>158</sup> or which portions of mass assets that are in a separate GAA<sup>159</sup> have been disposed of by the taxpayer from the specific identification method<sup>160</sup> to a mortality dispersion table<sup>161</sup> (using a cut-off method and applying to dispositions occurring on or after the beginning of the year of change)

<sup>146</sup> See IRC §168(i)(4) and related regulations.

<sup>147</sup> In accordance with Treas. Reg. §1.168(i)-1(c).

<sup>148</sup> Under Treas. Reg. §1.168(i)-1(j)(2)(i)(A).

<sup>149</sup> Under Treas. Reg. §1.168(i)-1(j)(2)(i)(B).

<sup>150</sup> Under Treas. Reg. §1.168(i)-1(j)(2)(i)(C).

<sup>151</sup> Under Treas. Reg. §1.168(i)-1(j)(2)(i)(B).

<sup>152</sup> Under Treas. Reg. §1.168(i)-1(j)(2)(i)(C).

<sup>153</sup> Under Treas. Reg. §1.168(i)-1(j)(2)(i)(A).

<sup>154</sup> See Treas. Reg. §1.168(i)-1(e)(3).

<sup>155</sup> Under Treas. Reg. §1.168(i)-1(j)(2)(i)(B).

<sup>156</sup> Under Treas. Reg. §1.168(i)-1(j)(2)(i)(C).

<sup>157</sup> See Treas. Reg. §1.168(i)-1(e)(3).

<sup>158</sup> As defined in Treas. Reg. §1.168(i)-1(b)(6).

<sup>159</sup> In accordance with Treas. Reg. §1.168(i)-1(c)(2)(ii)(H).

<sup>160</sup> Under Treas. Reg. §1.168(i)-1(j)(2)(i)(A).

<sup>161</sup> In accordance with Treas. Reg. §1.168(i)-1(j)(2)(i)(D).

6. A change in the method of identifying which mass assets<sup>162</sup> or which portions of mass assets that are in a separate GAA<sup>163</sup> have been disposed of by the taxpayer from the FIFO method<sup>164</sup> or the modified FIFO method<sup>165</sup> to a mortality dispersion table<sup>166</sup> (using a §481(a) adjustment, but the §481(a) adjustment should be zero unless the special rules for terminating GAAs<sup>167</sup> apply to the asset subject to the change)
7. A change in the method of identifying which mass assets<sup>168</sup> or which portions of mass assets that are in a separate GAA<sup>169</sup> have been disposed of by the taxpayer from a mortality dispersion table<sup>170</sup> to the specific identification method,<sup>171</sup> the FIFO method,<sup>172</sup> or the modified FIFO method<sup>173</sup> (using a §481(a) adjustment, but the §481(a) adjustment should be zero unless the special rules for terminating GAAs<sup>174</sup> apply to the asset subject to the change)
8. A change in the method of determining the unadjusted depreciable basis of all assets in the same GAA from one reasonable method to another reasonable method (using a cut-off method and applying to dispositions occurring on or after the beginning of the year of change) (This change applies<sup>175</sup> if the basis of a disposed asset or a disposed portion of an asset is included in a GAA and it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed asset or the disposed portion of the asset.)

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<sup>162</sup>. As defined in Treas. Reg. §1.168(i)-1(b)(6).

<sup>163</sup>. In accordance with Treas. Reg. §1.168-1(c)(2)(ii)(H).

<sup>164</sup>. Under Treas. Reg. §1.168(i)-1(j)(2)(i)(B).

<sup>165</sup>. Under Treas. Reg. §1.168(i)-1(j)(2)(i)(C).

<sup>166</sup>. In accordance with Treas. Reg. §1.168(i)-1(j)(2)(i)(D).

<sup>167</sup>. See Treas. Reg. §1.168(i)-1(e)(3).

<sup>168</sup>. As defined in Treas. Reg. §1.168(i)-1(b)(6).

<sup>169</sup>. In accordance with Treas. Reg. §1.168-1(c)(2)(ii)(H).

<sup>170</sup>. In accordance with Treas. Reg. §1.168(i)-1(j)(2)(i)(D).

<sup>171</sup>. Under Treas. Reg. §1.168(i)-1(j)(2)(i)(A).

<sup>172</sup>. Under Treas. Reg. §1.168(i)-1(j)(2)(i)(B).

<sup>173</sup>. Under Treas. Reg. §1.168(i)-1(j)(2)(i)(C).

<sup>174</sup>. See Treas. Reg. §1.168(i)-1(e)(3).

<sup>175</sup>. Under Treas. Reg. §1.168(i)-1(j)(3).



## §6.38: Disposition of Buildings or Structural Components

Covered changes include the following.

1. A change to the appropriate asset<sup>176</sup> for purposes of determining which asset or portion of an asset has been disposed of<sup>177</sup>
2. A change in how assets are determined and a change from depreciating a disposed asset (or portion thereof) to recognizing a gain or loss on a partial disposition that occurred in a prior tax year (See **Example 14.**)
3. A change from depreciating a disposed asset or disposed portion of an asset to recognizing a gain or loss upon disposition for dispositions that occurred in a prior tax year (This change applies if the taxpayer's present method of accounting for structural components and buildings, condominium units, and cooperative units, as well as improvements or additions to such assets, is in accordance with the applicable regulations.)<sup>178</sup>
4. A change in the method of identifying which assets in multiple-asset accounts or which portions of assets have been disposed of from an improper method (e.g., the LIFO method) to an accounting method specified in the regulation<sup>179</sup>
5. A change in the method of determining the unadjusted depreciable basis of a disposed asset in a multiple-asset account<sup>180</sup> from a method of not using the taxpayer's records to a method of using the taxpayer's records (This change applies when it is practicable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed asset.)
6. A change in the method of determining the unadjusted depreciable basis of all assets in the same multiple-asset account<sup>181</sup> from an unreasonable method to a reasonable method (This change applies when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed asset. An example of an unreasonable method is discounting the cost of the replacement asset to its placed-in-service year cost using the Consumer Price Index.)
7. A change in the method of determining the unadjusted depreciable basis of the **disposed portion**<sup>182</sup> of an asset from a method of not using the taxpayer's records to a method of using the taxpayer's records (This change applies when it is practicable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed portion of the asset.)
8. A change in the method of determining the unadjusted depreciable basis of the **disposed portion**<sup>183</sup> of an asset from an unreasonable method to a reasonable method (This change applies when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed portion of the asset.)
9. A change from recognizing gain or loss under Temp. Treas. Reg. §1.168(i)-8T upon the disposition of an asset<sup>184</sup> included in a GAA to recognizing gain or loss upon the disposition of the same asset under Treas. Reg. §1.168(i)-8

<sup>176</sup>. As determined under Treas. Reg. §1.168(i)-8(c)(4)(ii)(A), (B), or (D), as applicable.

<sup>177</sup>. Based on Treas. Reg. §1.168(i)-8(c)(4).

<sup>178</sup>. In accordance with Treas. Reg. §1.168(i)-8(c)(4)(ii)(A), (B), and (D).

<sup>179</sup>. In accordance with Treas. Reg. §1.168(i)-8(g)(1) or (2)(i), (ii), or (iii), as applicable.

<sup>180</sup>. Under Treas. Reg. §1.168(i)-8(f)(2).

<sup>181</sup>. Under Treas. Reg. §1.168(i)-8(f)(2).

<sup>182</sup>. Under Treas. Reg. §1.168(i)-8(f)(3).

<sup>183</sup>. Under Treas. Reg. §1.168(i)-8(f)(3).

<sup>184</sup>. As determined under Treas. Reg. §1.168(i)-8(c)(4)(ii)(A), (B), or (D), as applicable.

## §6.39: Dispositions of Certain Tangible Depreciable Assets

Instructions for the following types of changes in accounting method are included in this section.

1. For purposes of determining the asset disposed of, a change to the appropriate asset<sup>185</sup>
2. A change in how assets are determined **and** a change from depreciating a disposed asset (or portion thereof) to recognizing a gain or loss on a partial disposition that occurred in a prior tax year
3. A change from depreciating a disposed asset or disposed portion of an asset to recognizing a gain or loss upon disposition for dispositions that occurred in a prior tax year (This change applies if the taxpayer's present method of accounting for the covered assets is in accordance with the applicable regulations.)<sup>186</sup>
4. A change in the method of identifying which assets in multiple-asset accounts or which portions of assets have been disposed of from using an improper method (e.g., the LIFO method) to a method of accounting specified in the regulations<sup>187</sup>
5. A change in the method of determining the unadjusted depreciable basis of a disposed asset in a multiple-asset account<sup>188</sup> from a method of not using the taxpayer's records to a method of using the taxpayer's records (This change applies when it is practicable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed asset.)
6. A change in the method of determining the unadjusted depreciable basis of all assets in the same multiple-asset account<sup>189</sup> from an unreasonable method to a reasonable method (This change applies when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed asset. An example of an unreasonable method is discounting the cost of the replacement asset to its placed-in-service year cost using the Consumer Price Index.)
7. A change in the method of determining the unadjusted depreciable basis of the **disposed portion**<sup>190</sup> of an asset from a method of not using the taxpayer's records to a method of using the taxpayer's records (This change applies when it is practicable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed portion of the asset.)
8. A change in the method of determining the unadjusted depreciable basis of the **disposed portion**<sup>191</sup> of an asset from an unreasonable method to a reasonable method (This change applies when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed portion of the asset.)
9. A change from recognizing gain or loss under Temp. Treas. Reg. §1.168(i)-8T upon the disposition of an asset covered in this section that was included in a GAA to recognizing gain or loss upon the disposition of the same asset under Treas. Reg. §1.168(i)-8

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<sup>185</sup>. As determined under Treas. Reg. §1.168(i)-8(c)(4)(i), (ii)(C), or (ii)(D), as applicable.

<sup>186</sup>. In accordance with Treas. Reg. §1.168(i)-8(c)(4)(i) or (ii).

<sup>187</sup>. As determined under Treas. Reg. §1.168(i)-8(g)(1) or (2)(i), (ii), or (iii), as applicable.

<sup>188</sup>. Under Treas. Reg. §1.168(i)-8(f)(2).

<sup>189</sup>. Under Treas. Reg. §1.168(i)-8(f)(2).

<sup>190</sup>. Under Treas. Reg. §1.168(i)-8(f)(3).

<sup>191</sup>. Under Treas. Reg. §1.168(i)-8(f)(3).

## §6.40: Dispositions of Tangible Depreciable Assets in a GAA

Instructions for the following types of changes in accounting method are included in this section.

This section applies only to the following changes in methods of accounting for an asset subject to a GAA election.

1. For purposes of determining the asset disposed of,<sup>192</sup> a change to the appropriate asset<sup>193</sup>
2. A change in the method of identifying which assets or which portion of assets have been disposed of from an accounting method not specified in the regulations<sup>194</sup> (e.g., the LIFO method) to an accounting method specified in these regulations
3. A change in the method of determining the unadjusted depreciable basis of a disposed asset<sup>195</sup> (or portion of an asset) from a method of not using the taxpayer's records to a method of using the taxpayer's records (This change applies when it is practicable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed asset.)
4. A change in the method of determining the unadjusted depreciable basis<sup>196</sup> of all assets in the same GAA from an unreasonable method to a reasonable method (This change applies when it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed asset. An example of an unreasonable method is discounting the cost of the replacement asset to its placed-in-service year cost using the Consumer Price Index.)

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<sup>192</sup>. Under Treas. Reg. §1.168(i)-1(e)(2)(viii).

<sup>193</sup>. As determined under Treas. Reg. §1.168(i)-1(e)(2)(viii)(A) or (B), as applicable.

<sup>194</sup>. Treas. Reg. §1.168(i)-1(j)(2)(i)(A), (B), (C), or (D).

<sup>195</sup>. Under Treas. Reg. §1.168(i)-1(j)(3).

<sup>196</sup>. Under Treas. Reg. §1.168(i)-1(j)(3).

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