FAQ - Forms 3115 and the new Tangible Property Regulations (TPRs)

Q. What are the final tangible property regulations (TPRs)?

A. *Generally, the final tangible property regulations that took effect in 2014 are the codification of all previous guidance—temporary regulations, revenue procedures, court cases, etc.—regarding when and how an expenditure or improvement effort should be expensed or capitalized/depreciated. These final authoritative rules set forth various tests, safe harbors, and elections for the tax treatment of typical expenditures. The specific regulations are Reg §§ 1.263(a)-1, 1.263(a)-2, 1.263(a)-3, 1.263(a)-6, 1.162-3, 1.162-4, 1.162-11, 1.167(a)-4, 1.168(i)-1, 1.168(i)-7, 1.168(i)-8 and 1.1016-3. In most of these regulations, it states that a change to comply with these regulations is a change in accounting method, requiring consent of the Commissioner.*

Q. What do the TPRs mean to me as a business owner?

A. *Simply put, all taxpayers must now comply with the final issued TPRs. This includes adapting your company's accounting policies to be in compliance of the new regulations.*

Q. What does that mean that I must "adapt my policies to the final regulations?"

A. *First, all businesses must file for a change in accounting method on Form 3115 with their 2014 tax return to change from an accounting method under the old guidance to adopting the rules under the new guidance. Second, implementation of the new guidance/policies must occur in one's business. See last question for details.*

Q. How much will it cost for the additional Form 3115 to be included in my 2014 tax return?

A. *Form 3115 must be filed before the 2014 tax return is filed, but a* ***copy*** *must be attached to the 2014 tax return. Therefore, preparation of the Form 3115 must be done beforehand under its own arrangement. Per the IRS instructions it takes 20 hours to learn about the law and form, 39 hours for recordkeeping (work papers), and 24 hours to prepare Form 3115. As professionals, we know the law and can complete the form and work papers in a quarter of the time. As such, it should take a professional about 16 hours to "scrub" depreciation and prepare the required 3115's. Preparation of 3115s is possible in a few hours for companies that do not require depreciation "scrubbing."*

Q. My accounting policy has *always* been tax basis, and my intent is to continue this accounting method in compliance with these final rules. Why then am I required to pay for, essentially, an extra tax return to change my method of accounting?

A. *Your definition of "accounting method" may be different from that of the IRS's definition. While your* ***basis*** *of accounting is compliant with all income tax rules and regulations, your* ***method*** *of accounting is based on what actually occurred in your tax filing and bookkeeping. For example, guidance from the IRS in previous years was to capitalize most large purchases, but now the final regulations require testing of all expenditures for being a betterment, adaptation, or restoration to determine if an item should be capitalized.*
A method of accounting for tax purposes is established after treating an item consistently for at least two tax filings. Once a method of accounting is established, consent to switch to a new method of accounting must be obtained from the Commissioner. This is even true to switch from an impermissible method of accounting to a permissible method of accounting. Consent from the Commissioner can be obtained automatically without a user fee in most cases by filing the correct method change on Form 3115.

Q. Wait… I heard methods of accounting are established on an asset-by-asset basis. My wish is to apply the new regulations going forward on an asset-by-asset basis without filing Forms 3115, just like it has always been done?

A. *It is true that a depreciation method of accounting is generally established on asset-by-asset basis. It is also true these final tangible property regulations do cross-reference with depreciation; however, these remain two different issues. The difference lies in the specific regulation for each method change. For depreciation accounting method changes, Reg §1.446-1(e)(2)(ii)(d)(2) specifically states, "a change in the* ***treatment of an asset*** *from nondepreciable … to depreciable …, or vice versa, is a change in method of accounting." The final tangible property regulations—for instance at Reg §1.263(a)-3(q)—states, "a change to* ***comply with this section*** *is a change in method of accounting." Depreciation changes may be implemented on a prospective asset-by-asset basis, but changes to the capitalization criteria of the TPRs must now be applied to all existing and future assets in order to comply with "this section" of the final regulations.*

Q. I have heard about a $7,000 user fee. What is that?

A*. The $7,000 user fee applies to a taxpayer seeking* ***non****-automatic consent for an accounting method change. The 3115's required to comply with the TPRs generally receive* ***automatic*** *consent without a user fee, BUT after 2014 there will be cases where an* ***automatic*** *method change may not be available because of "scope limitations." Through 2014, the IRS has waived all normal scope limitations to accommodate compliance with the TPRs. For example, one scope limitation allows for only one accounting method change every five years. In another case, scope limitations limit certain taxpayers with Section 263A (self-constructed assets) method changes to* ***non****-automatic consent. Through 2014, all taxpayers will be given automatic consent in spite of these limitations. After 2014, these*

scope limitations will again be applicable, and changing method of accounting may require a $7,000 fee.

Q. I started my business in 2013. Must I file a Form 3115?

A. *Generally no,* ***if*** *your return was prepared professionally in full consideration of the final regulations. However, if old guidance on tangible property was used in preparation of your 2013 return or assets from a previous year were added to the business, you may need to amend your 2013 tax return and/or complete a Form 3115 to comply with the final regulations. Examples include capitalizing a (now deemed) repair under old guidance or contributing assets from a previous business to a new partnership.*

Q. I can't really afford an extra tax return fee this year. What if I don't file a Form 3115?

A. *The IRS has stated they will wait until all 2014 returns have been filed before auditing these TPR issues [LB&I-04-0313-001], and then scrutinize returns that did not include a Form 3115 with their 2014 tax return. Generally, it is presumed that essentially every business with material and supplies or depreciation has been using an incorrect method of accounting, because the final regulations adopted some new guidance contrary to "how it was always done before." Chances of a tax return audit increase significantly if a Form 3115 is not filed. In addition, if your tax preparer signs your return without your compliance of the regulations, they may be at risk of penalty and disbarment (Reg §§ 10.50 & 10.51) for violating their professional standards (Circular 230) by having knowledge of your noncompliance (Reg §10.21) yet still signing your tax return in reckless disregard of the regulations (Reg §10.34).*

Q. What is the risk of not filing a Form 3115?

A. *Permanent loss of deductions, penalties, and risk of an IRS audit*

exists for those who do not file a Form 3115. Under the "use it or lose it" rules of depreciation, any improperly capitalized (and depreciated) assets or repairs could be permanently lost as a deduction. Reg 1.1016-3 became final with these TPRs allowing the IRS to now enforce this "allowed or allowable" rule. Conversely, claiming too much depreciation that is not allowable could subject one to 20% understatement penalties. Through 2014, the IRS is also allowing one to dispose of the replaced portion of an improved asset in a late partial disposition. Such late partial disposition allows one to write-off the old replaced component, resulting in a permanent tax saving by eliminating "dual depreciation" and recapture on the disposed component.These late partial asset dispositions will not be available after 2014.

Risk of audit is also substantial if a Form 3115 is not filed with your 2012, 2013, or 2014 tax return. Upon audit, the IRS has broad discretion on what method of accounting best reflects income, which would likely not be in favor of the taxpayer. Per an examiner's discretion, the agent could move, defer, or deny a deduction if no 3115 was filed. In this case, the laws and regulations support the IRS either way, because the final regulations require one thing (new rules) but allow another (old or impermissible rules) if not properly implemented.

Example: Writing off routine maintenance under the new rules without ever filing a 3115 to adopt the new rules could allow an auditor to mandate capitalization of those repairs. Or an auditor could claim your capitalized repairs should have been written off and deny the depreciation deduction taken, and if such expenditure was more than 3 years old, that deduction would be permanently lost. In theory, it is possible a taxpayer's previous accounting method may have been compliant with the final TPRs by mere happenstance; however, the reality is the final TPRs are so extensive that such a possibility is nearly remote. For instance, previously capitalizing an expenditure that should have been a repair (in light of the new regs) makes it necessary to change accounting methods.

Q. The cost-benefit for filing a Form 3115 isn't favorable. Why should I file a Form 3115?

A. *Rarely does anyone consider filing an income tax return favorable from a cost-benefit analysis, however, a taxpayer is still compelled to file their annual tax return. The same thing applies to filing this "extra" Form 3115. It's a cost of doing business in the socioeconomic system we live. Nonetheless, a benefit may be received by being able to write off items that are improperly being depreciated in view of the final regulations.*
Even when benefit may be obtained through these Form 3115 filings, such benefit is not the main point of the 3115 filings. A taxpayer must file a 3115 in order to change their method of accounting to comply with the final rules. Although the final rules employ previous revenue procedures, rulings, bulletins, law, and temporary regulation, the TPRs also incorporate new and superseded rules. As such, Forms 3115 must be filed to enable the right to correctly employ the new regulations.

Q. Wait a minute... I pay you to prepare my taxes in accordance with all rules and regulations. The reason I pay you is because I don't understand all the rules and want to be compliant with the law. Why should I pay to fix your mistake?

A. *The requirement to file a Form 3115 for these latest rules is not synonymous with a tax preparer mistake. Rather, the Form 3115 filing is a new requirement and the hazards of noncompliance can be substantial to both the preparer and taxpayer. At times prior guidance may have been self-conflicting so one objective of the final regulations was to reconcile all guidance into one concise set of rules. These new rules require Form 3115 be filed to change your method of accounting to the final TPRs; after all, how could a taxpayer already be complying with the new TPR accounting methods that were only issued in September of 2013?*

Q. I heard "no one else is doing this." Will the IRS audit everyone?

A. *The obligation to our clients is to provide optimum service through*

the least amount of taxes allowable under the law. Not only does the law require compliance via a Form 3115, the potential hazards of future monetary liability are significant without proper compliance. Not complying may be like handing the IRS a free pass to an unfavorable tax assessment in a future audit. Regardless of the IRS's logistical ability to audit, we are ethically obligated to our clients to do the right thing. Further, we may be professionally unable to sign your return without the proper 3115.

Q. Besides filing Forms 3115, what else constitutes compliance with these final TPRs?
A. *The final tangible repair regulations involve six possible annual elections; various safe harbors; specific rules on materials and supplies; and guidance on how to treat acquisition, disposition, and improvement costs of a unit of property. The "meat" of the regulations deals with determining if an expenditure is an improvement by testing for betterment, adaptation, or restoration; if not an improvement under this test, it is a repair expense. One of the annual "must file" elections is the de minimis safe harbor, which allows one to write off expenditures up to $500 or $5,000 depending on your situation. A new routine maintenance safe harbor allows for expensing of costs expected to be incurred more than once over the class life of the asset or more than once over a 10-year period if its real property. General materials and supplies can be written off if under the de minimis amount, but must be tracked and deferred if the cost is greater than the de minimis amount and used in a later year. Inherently facilitative acquisition costs must be capitalized, and a new rule allows for the partial disposition of a replaced asset's component. It is recommended a carefully written accounting policy be implemented covering these general rules.*

ADDENDUM
Q. I heard the AICPA and most State Societies of CPA's are petitioning the IRS to not require the filing of these Forms 3115 to adopt the final tangible property regulations. Surely, the IRS will give in to the pressure. Shouldn't we wait to see whether

these filings will definitely be required?

A. *It is true that the AICPA and other State CPA Societies are advocating for prospective adoption of the final tangible property regulations without requiring Forms 3115. The likelihood the Commissioner will acquiesce to this pressure remains to be seen. Nonetheless, the requirement for a Form 3115 will always remain when there is an adjustment to taxable income [IRC §481(a)(2)]. Correcting other items related to these regs, such as unit of property definitions, may need a 3115 anyway. Therefore, filing 3115's as a protective measure is a good idea even if the IRS decides these regulations can be adopted prospectively. See next question for more discussion on the likelihood the IRS will grant a 3115 filing exception as requested by the accounting profession.*

Q. So will the Commissioner make an exception to filing Form 3115 for adopting the final TPRs where no adjustment is necessary?

A. *Perhaps… That would be a most reasonable and fair exception considering Form 3115 is meant to illustrate the calculated income adjustment from switching accounting methods. But let us consider the facts thus far. Internal Revenue Code §446(e) requires any accounting method change to get consent from the IRS. Reg 1.446-1 provides the general procedures (i.e. Form 3115) for obtaining the required consent, while Revenue Procedures 2015-13 & 2015-14 detail specific guidance on achieving consent. An old regulation §1.446-1(e)(2)(d) specifically requires changes in depreciation receive consent before making changes to depreciation. The latest and most recent final tangible property regulations (e.g. Reg 1.263(a)-3(q), 1.168(i)-8(j)(5), etc.) also requires permission to change to those regulations. Finally, the IRS has issued several revenue procedures [Rev Proc 2014-16, 2014-17, 2014-54 (now superseded by Rev Proc 2015-14)] detailing how consent for adopting these final TPRs be obtained, and the IRS has made the 3115 requirements less stringent for small taxpayers.*
The IRS appears to have the legal authority to make an exception to

filing these 3115's where no 481(a) adjustment is required, but taking this discretion would be contrary to regulatory precedent and require the IRS to renege on their own previous guidance.

Regardless, my experience in "scrubbing" depreciation schedules has been that taxpayers with many assets have most often required a 481(a) adjustment to "correct" prior periods. Changing existing depreciation to comply with the new TPRs is a "must," because failure to do so leaves one open to future liability as discussed in this FAQ. The fact that the "allowed or allowable" regulation (Reg 1.1016-3), which has been temporary since the 1950's, became final and effective this year suggests the IRS will now begin scrutinizing depreciation for audit adjustments. Should a taxpayer's depreciation be incorrect in consideration of the new regulations, the risk of an unfavorable audit adjustment is high.

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(Link to original article here)