IRS Eliminates the Form 3115 Requirement for Small Businesses

A. Introduction

1. On Valentines day, February 14, 2015, the IRS issued Rev. Proc. 2015-20. This Rev. Proc. allows taxpayers to make changes in accounting methods for 2014 without having to file a Form 3115. To qualify to use Rev. Proc. 2015-20, the taxpayer must be considered to be a small business taxpayer.

B. Definition of Small Business Taxpayer

1. A small business taxpayer is defined as a business with (1) total assets of less than $10 million or (2) average annual gross receipts of $10 million or less for the prior three taxable years. This is different than Rev. Proc. 2015-14, where a “qualified small taxpayer” was defined as a taxpayer whose average annual gross receipts for the three preceding taxable years is less than or equal to $10 million. That provision allowed qualified small taxpayers to have a reduced filing requirement with regards to Form 3115.

    a. This “small business taxpayer” applies to each separate business of the taxpayer meeting the requirements..

C. Making the Change in Accounting Method

1. The taxpayer can change their various methods of accounting to comply with the final tangible property regulations by making the changes on their books and records. They will not file any Forms 3115. A Sec. 481(a) adjustment will only be required if the taxpayer has amounts paid or incurred and dispositions in taxable years beginning on or after January 1, 2014 (2014 tax return).

2. While some small business taxpayer may choose to file a Form 3115 in order to retain a clear record of a change in method of accounting or to make permissible concurrent automatic changes on the same for, other small business taxpayer may prefer the administrative convenience of being able to comply with the final tangible property regulations in their 2014 tax year solely through the filing of a federal tax return. Accordingly, for the 2014 tax return, small business taxpayer that choose to prospectively apply the tangible property regulations to amounts paid or incurred, and dispositions, in taxable years beginning on or after the 2014 tax return, have the option of making certain tangible property change in method of accounting on the federal tax return without including a separate Form 3115 or separate statement.

3. For a small business taxpayer that chooses to make a tangible property disposition change that only takes into account disposition in 2014 and succeeding taxable years, it is unnecessary and inappropriate to permit a late partial disposition election, which would permit partial dispositions for taxable years beginning prior to January 1, 2014.

4. A transition rule is provided for taxpayers that have previously filed their 2014 federal tax return, permitting withdrawal of the filed Form 3115 through the filing of an amended return on or before the due date of the taxpayer’s timely filed (including any extension) original federal income tax return for the requested year of change.

5. Thus, taxpayers are required to be in compliance with the tangible property regulations through changes in accounting method. However, they are able to institute the change of accounting method without filing a Form 3115 and institute the change on a cutoff method (no Sec. 481(a) adjustment.

D. Required Changes in Accounting Method

1. Incidental Materials and Supplies

    a. Incidental materials and supplies are deducted in the tax year their cost is paid or incurred. [Reg. 1.162-3(a)(2)]

    b. If not already using that method, change to the correct method by beginning that policy in 2014. Any incidental materials and supplies in inventory would be expensed in 2014.

2. Non-Incidental Materials and Supplies

    a. The cost of a non-incidental material or supply is deducted in the year the item is used or consumed. [Reg. 1.162-3(a)(1)]

    b. If not already using that method, change to the correct method by beginning policy in 2014. Any non-incidental materials and supplies expensed in the past are ignored.

3. Rotable and Temporary Spare Parts

    a. Rotable and temporary spare parts are first used in the taxpayer's operations or are consumed in the taxpayer's operations in the taxable year in which the taxpayer disposed of the parts. [Reg. 1.162-3(a)[2)]

    b. If not already using that method, change to the correct method by beginning policy in 2014. Any rotable or temporary spare parts expensed in the past are ignored.

4. Standby Emergency Spare Parts

    a. Generally deducted when the part is first used or consumed. [Reg. 1.162-3(c)(3)]

    b. If not already using that method, change to the correct method by beginning policy in 2014. Any standby emergency spare parts expensed in the past are ignored.

5. Amounts Paid to Acquire or Produce Tangible Property

    a. A taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property, including leasehold improvements, land and land improvement, building, machinery and equipment, and furniture and fixtures. [Reg. 1.263(a)-2(d)]

    b. If not already using that method, change to the correct method by beginning policy in 2014. Any amounts paid to acquire or produce tangible property expensed in the past are ignored.

6. Capitalization Standards for Improvements, Betterments, and Adaptions

    a. Under the final regulations, an expenditure must be capitalized if it results in a betterment to the unit of property, results in a restoration of the unit of property, or adapts the unit of property to a new or different use. [Reg. 1.263(a)-3(j), (k) & (l)]

    b. If not already using that method, change to the correct method by beginning policy in 2014. Any amounts paid for improvements, betterments, and adaption expensed in the past are ignored.

7. Identifying a Unit of Property

   a. A taxpayer using a unit-of-property definition that differs from the definition in the final regulations is using an improper accounting method. A change includes the method of identifying the unit of property, or in the case of a building, identifying the building structure or building systems. [Reg. 1.263(a)-3]

   b. Change to the correct method by beginning policy in 2014. Any amounts previously expenses that should have been capitalized are left alone. Any amount capitalized that should have been expenses are continued to be depreciated.

8. Removal Costs

   a. Removal costs are deductible if, for federal tax purposes, the taxpayer disposes of the depreciable asset being removed and takes its basis into account in realizing gain or loss. [Reg. 1.263(a)-3(g)(2)(i)]

   b. If not already using that method, change to the correct method by beginning policy in 2014. Continue to depreciation any amounts paid for removal costs capitalized in the past..

9. Late Partial Dispositions

   a. A disposition includes a disposition of a portion of an asset only if the taxpayer makes the partial disposition election for that disposed portion.

   b. The partial disposition election is not an accounting method except that the IRS allows certain retroactive elections by filing an accounting method change. Taxpayers may make a late partial disposition election on the 2014 tax return by filing a Form 3115 Change of Accounting Method. In doing so, they are allowed to take a loss for the remaining basis of the disposed asset. The late partial election will require a Sec. 481(a) adjustment.

E. Audit Protection Not Available

1. Because taxable years beginning before 2014 are not taken into account by a small business taxpayer using the Non-Form 3115 change in accounting method, audit protection is not provided for years previous to 2014.

2. This means, for example, that if you expensed a roof that you replaced in 2010 the IRS could require you to capitalize the roof replacement, subtract the depreciation for the meantime and make a Sec. 481(a) adjustment for the difference.

F. Annual Elections Made by Attaching Statement to the Tax Return

1. Elective $5,000/$500 Per-Item Book-Conformity Safe Harbor

   a. The election is made by attaching a statement to the taxpayer’s timely filed original return (including extensions) for the year in which the amounts are paid. [Reg. 1.263(a)-1(f)(5)]

   b. This statement is attached each year.

2. Capitalization Safe Harbor

   a. Under the capitalization safe harbor, the taxpayer may elect to treat as capital expenditures for tax purposes those repair and maintenance cost that it treats as capital improvements on its books and records. [Reg. 1.263(a)-3(n)(1)]

   b. The book capitalization safe harbor is an annual election rather than an accounting method. The election is made by attaching a statement to the taxpayer's original return for the year in which it incurs the amounts to be capitalized. [Reg. 1.263(a)-13(n)(2)]

3. Small Business Building Expense Safe Harbor

   a. The regulations permit a qualifying small taxpayer to elect to not apply the improvement rules to an eligible business property if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of $10,000 or 2 percent of the unadjusted basis of the building. [Reg. 1.263(a)-3(h)(1)]

   b. The safe harbor for building property held by small taxpayers may be elected annually on a building-by-building basis by including a statement on the taxpayer's timely filed original Federal tax return, including extensions, for the year the costs are incurred for the building. [Reg. 1.263(a)-3(h)(6)]

G. Simplified Procedure of Rev. Proc. 2015-20 is Optional

1. Taxpayers are still free to file Form 3115 if they so desire.

2. A taxpayer desiring to make a partial asset disposition of an asset disposed of before 2014 will be required to file a Form 3115, including a Sec. 481(a) adjustment.

3. Example Late Partial Disposition: Purchased building 6-1-2008 for $10,000,000; Cost segregation study shows roof at $100,000; 1-1-2012 entire roof replaced for $150,000; Accumulated depreciation 12-31-2011 – $9,081; $90,919 loss on disposal ($100,000 - $9,081).

   a. File a Form 3115 with a Designated Change Number 196 and a negative Sec. 481(a) adjustment of $90,919. Cite Reg. §1.168(i)-8.