

WNTS Insight

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Accounting method changes under the tangible property regulations: depreciation and dispositions of property

Rev. Proc. 2012-20, released on March 7, provides the change in method of accounting procedures related to depreciation and dispositions of property under the temporary and proposed regulations issued on December 23, 2011. These regulations address the deduction and capitalization of expenditures related to tangible property (temporary or repair regulations).

The IRS at the same time released Rev. Proc. 2012-19, providing rules for taxpayers making accounting method changes related to deduction and capitalization of expenditures under the temporary regulations. For in-depth analysis of Rev. Proc. 2012-19, see WNTS Insight, "[Accounting method changes under the tangible property regulations: deduction and capitalization of expenditures](#)," March 13, 2012

For prior coverage of Rev. Procs. 2012-19 and 2012-20, see WNTS Insight, "[IRS releases revenue procedures on accounting method changes related to the tangible property repair regulations](#)," March 7, 2012. For in-depth analysis of the repair regulations, see WNTS Insights, "[The tangible property repair regulations: effective dates, units of property, and dispositions](#)," January 4, 2012; "[The tangible property repair regulations: acquisition or improvement of property](#)," January 5, 2012; and "[The tangible property repair regulations: plan of rehabilitation, environmental remediation, rotatable spare parts, general asset accounts, removal costs, and recovery of certain capital improvements](#)," January 6, 2012.



Background

The temporary regulations apply for tax years beginning on or after January 1, 2012, or to amounts paid or incurred in tax years beginning on or after January 1, 2012, as applicable. Accordingly, beginning in 2012, all taxpayers likely will have to change their method of accounting to conform to the temporary regulations.

The temporary regulations include guidance related to the depreciation and disposition of Modified Accelerated Cost Recovery System (MACRS) property and leasehold improvements. Rev. Proc. 2012-20 provides guidance for taxpayers that wish to change their methods of accounting relating to leased property, general asset accounts, depreciation of MACRS property, and dispositions of MACRS property. Of significant note is the transition rule temporarily permitting taxpayers to make a late election to include property in a general asset account (see discussion below of general asset account election).

Key aspects of new revenue procedure

Rev. Proc. 2012-19 modifies Rev. Proc. 2011-14, which provides general procedures for obtaining automatic consent to method changes, by adding new automatic accounting method changes to the Appendix of Rev. Proc. 2011-14. The new automatic changes reflect the methods of accounting described in the temporary regulations.

In general, the new automatic accounting method changes provided by Rev. Proc. 2012-20 contain similar procedural rules relating to audit protection and scope limitations. However, there are some differences regarding section 481(a) adjustments. These items and specific repair method changes are discussed in more detail below.

Specifically, Rev. Proc. 2012-20 modifies Rev. Proc. 2011-14 by obsoleting and removing the earlier automatic method change provisions relating to dispositions of structural components of a building and dispositions of tangible depreciable assets (other than a building or its structural components), effective for tax years beginning on or after January 1, 2012.

Rev. Proc. 2012-20 further modifies Rev. Proc. 2011-14 by providing automatic method change procedures for the following method changes:

- Depreciation of leasehold improvements;
- Changing from one permissible method to another permissible method of accounting for depreciation of MACRS property;
- Disposition of a building or structural component;
- Dispositions of tangible depreciable assets (other than a building or its structural components);
- Dispositions of tangible depreciable assets in a general asset account; and
- General asset account elections.

Section 481(a) adjustments vs. cut-off method

Reg. sec. 1.446-1(e)(2)(ii)(d)(5)(iii) generally provides whether a method change for depreciable or amortizable assets results in a section 481(a) adjustment or should be accounted for on a cut-off basis. Under this provision, changes from one permissible

method of accounting to another are implemented by either a cut-off method or a modified cut-off method, unless expressly stated otherwise in the Internal Revenue Code, the regulations thereunder, or other published guidance. Changes from an impermissible method to a permissible method result in a section 481(a) adjustment.

Note: A section 481(a) adjustment accounts for the cumulative difference between the current and proposed accounting methods for the item as of the beginning of the year of change. This adjustment has the current-year effect of retroactively applying the proposed method of accounting via a "catch-up" adjustment.

When a method change may be performed on a cut-off basis, no "catch-up" adjustment is made. Instead, only the items arising on or after the beginning of the year of change are accounted for under the new method; items arising before the year of change continue to be accounted for under the taxpayer's former method of accounting. Rev. Proc. 2012-20 further prescribes a modified cut-off for certain changes, whereby the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method.

Except as highlighted below, the six new automatic method changes for depreciation and dispositions follow the guidance provided in Reg. sec. 1.446-1(e)(2)(ii)(d)(5)(iii) regarding section 481 adjustments.

Audit protection

The repair regulations do not modify the general rule affording audit protection or "amnesty" for a taxpayer that voluntarily changes from an improper method of accounting to a method permitted by the temporary regulations. Specifically, under this amnesty approach, a taxpayer that voluntarily changes from an improper to a proper method of accounting receives a commitment from the IRS that it will not make an examination adjustment relating to the taxpayer's use of the improper method for any prior tax year. Audit protection for changes made under Rev. Proc. 2012-20 begins on the date the Form 3115, *Application for Change in Accounting Method*, is filed with the IRS in Ogden, UT, in lieu of the IRS National Office.

Observation: For a taxpayer being examined with respect to a prior tax year for its treatment of repairs, the audit protection afforded by a change in method of accounting effectively will require the IRS to discontinue its examinations of the issue included in the Form 3115 for years prior to the year of change. Similar audit protection, however, is not given to taxpayers before the IRS Appeals Division on the issue that is the subject to the method change. Therefore, the IRS could continue its consideration of cases before Appeals; no announcement has been made to the public on this point.

Scope limitations

In general, a taxpayer that is under examination, has engaged in a transaction to which section 381(a) applies, is in the final year of its trade or business, or has changed its method of accounting for the same item within the past five years may not file an accounting method change under the automatic consent procedures, but instead must file such method change on a non-automatic basis. However, Rev. Proc. 2012-20 waives these "scope" limitations (which are contained in section 4.02 of Rev. Proc. 2011-14) for the first or second tax year beginning after December 31, 2011. Therefore, a taxpayer filing during this period has the ability to file any of the new automatic accounting method changes under the automatic consent procedures.

Observation: The two-year period allows a taxpayer to file a change in method for its first tax year beginning after December 31, 2011, which is the first year to which the temporary regulations apply, and to file a second change in method for its second

tax year beginning after December 31, 2011, for the same change. Waiving the scope limitations for the second tax year gives taxpayers time to implement a change in the first year and correct any subsequent omissions in the second year.

Pre-2003 assets

Rev. Proc. 2012-20 provides an exception to the application of a method to assets placed in service in a tax year ending before December 30, 2003. For such assets, taxpayers either may file Form 3115 or may file amended returns, limited to years that are open under the statute of limitations, in lieu of Form 3115.

Depreciation of leasehold improvements

Rev. Proc. 2012-20 adds automatic procedures to change from an improper method of depreciating or amortizing a leasehold improvement over the length of the lease term, to a proper method of adopting the applicable cost recovery provisions under the Code, without regard to the length of the lease term.

Permissible to permissible method of accounting for depreciation of MACRS property

Rev. Proc. 2012-20 adds automatic procedures to change from one permissible method of accounting for MACRS depreciation to another permissible method of accounting for MACRS depreciation. In general, a taxpayer currently using a permissible method of accounting for depreciating MACRS property may change its accounting method for asset accounts (single, multiple, or general), as well as its method of accounting for dispositions from these accounts (specific identification, FIFO, modified FIFO, or mortality dispersion table).

These procedures specifically apply to a taxpayer that wishes to change its method of accounting for depreciation for a MACRS asset owned by the taxpayer at the beginning of the year of change and for which both the current and proposed methods of accounting are permissible under the section 168 temporary regulations regarding general asset accounts (GAAs), accounting for MACRS property, or dispositions of MACRS property. The changes do not apply to any property not being depreciated by the taxpayer under section 168.

The distinctions among the various changes depend on whether a valid GAA election has been made for the MACRS property under section 168(i)(4) and the regulations there under. If a taxpayer has not made a valid GAA election, a change may be made from a single asset account to a multiple asset account (MAA or pooling), and from one pooling method to another. If a taxpayer has made a valid GAA election, a change may be made from one GAA to another GAA (with a different grouping of the same assets). See discussion below regarding how taxpayers may make a valid late election to account for assets in GAAs.

Method changes for asset accounts (single, multiple, and general) are made using a modified cut-off method, under which the unadjusted depreciable basis and the depreciation reserve of the asset as of the beginning of the year of change are accounted for using the new method of accounting. When the change is to a single asset account, an MAA (either a new one or a different grouping), or a GAA, the new account must include the beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the assets included in that asset account.

A taxpayer also may change its method of accounting for identifying the MACRS asset disposed of, regardless of whether a valid GAA election has been made.

Method changes for dispositions of MACRS property are made on a cut-off basis or require a section 481(a) adjustment, depending on the taxpayer's current method of accounting for dispositions.

The below table summarizes these method changes:

Asset accounting	<u>Change in method to identify MACRS asset disposed*</u>		
	Current method	Proposed method	481(a) or cut-off
MAA or GAA**	Specific identification	FIFO, or modified FIFO	Cut-off
	FIFO, or modified FIFO	Specific identification	481(a) adjustment
	FIFO	Modified FIFO, or vice versa (modified FIFO to FIFO)	481(a) adjustment
MAA or GAA ** for mass assets	Specific identification	Mortality dispersion table	Cut-off
	FIFO, or modified FIFO	Mortality dispersion table	481(a) adjustment
	Mortality dispersion table	Specific identification, FIFO, or modified FIFO	481(a) adjustment

* Table assumes conformity to the methods set forth in the respective disposition provisions under the temporary regulations

** Respective changes require a valid GAA election under section 168(i)(4) and the regulations thereunder

Disposition of a building or structural component

Rev. Proc. 2012-20 provides automatic method change procedures applicable to dispositions of a building or structural component. These procedures affect the determination of gain or loss from the disposition of the building or the structural component and may affect whether the taxpayer must capitalize amounts paid to restore a unit of property (UOP).

Rev. Proc. 2012-20 also provides guidance on how a taxpayer may change methods of accounting for a building, condominium unit, cooperative unit, structural component, or an improvement or addition thereto.

Specifically excluded from this method change is property for which a valid GAA election has been made. See discussion below for such assets.

Disposition of tangible depreciable assets other than a building or its structural components

Taxpayers may make this method change for section 1245 property or a depreciable land improvement to comply with the temporary regulations. This change will affect

the determination of gain or loss from the disposition of the section 1245 property or the depreciable land improvement and may affect whether the taxpayer must capitalize amounts paid to restore a UOP.

Rev. Proc. 2012-20 also includes procedures for how a taxpayer may change its methods of accounting for section 1245 property, a depreciable land improvement, or an improvement or addition thereto.

Specifically excluded from this method change is property for which a valid GAA election has been made. See discussion below for such assets.

Dispositions of tangible depreciable assets in a GAA

Taxpayers may make this method change for assets for which the taxpayer has made a valid GAA election, to comply with the temporary regulations. This change may affect the determination of gain or loss from the disposition of an asset from a GAA and may affect whether the taxpayer must capitalize amounts paid to restore a UOP.

Rev. Proc. 2012-20 also provides additional details regarding the specific changes covered by this method change for assets for which the taxpayer has made a valid GAA election.

Specifically excluded from this method change is property that is not depreciated under section 168. Also excluded is property for which a valid GAA election has not been made. See discussion above for such assets.

GAA elections

Under this method change, taxpayers, in the first two tax years beginning after December 31, 2011, may make late elections to use GAA for assets placed in service prior to January 1, 2012, or recognize gain or loss upon certain dispositions from GAAs. This method may affect whether the taxpayer must capitalize amounts paid to restore a UOP.

Specifically, the method changes to make a late election to recognize gain or loss upon the disposition of asset from a GAA apply to:

- The disposition of all the assets or the last asset in a GAA, or
- The disposition of an item of MACRS property in a qualifying disposition when the taxpayer has made a valid GAA election for that property.

Note: A late election generally is not a change in method of accounting (see Reg. sec. 1.446-1(e)(2)(ii)(d)(3)(iii)). As a result of the changes made by the temporary regulations to the disposition rules for assets in a GAA, the IRS has provided a taxpayer-favorable rule permitting taxpayers to make a late election by filing an automatic Form 3115, rather than by requesting a late election by filing a private letter ruling request under Reg. sec. 301.9100.

Changes in method of accounting made under this provision generally require a section 481(a) adjustment. There is an exception for a change made to elect the use of a GAA for assets placed in service prior to January 1, 2012, for one or more items of MACRS property owned by the taxpayer at the beginning of the year of change. In this case, the taxpayer should recognize the change using a modified cut-off method, under which the unadjusted depreciable basis and the depreciation reserve of the asset as of the beginning of the year of change are accounted for using the new method.

Statistical sampling guidance

The appropriateness of statistical sampling is covered in specific sections of Rev. Proc. 2012-20 on the disposition of a building, structural component dispositions, and the disposition of tangible depreciable assets (other than a building or its structural components), but is not addressed in other sections, such as the section on dispositions from GAAs. It appears that the IRS position is that in cases in which sampling is not discussed, it will be up to the field to make a determination. As a result, in no instance is sampling expressly disallowed.

When statistical sampling is used, Rev. Proc. 2012-20 requires taxpayers to follow the sampling guidance in Rev. Proc. 2011-42. The IRS largely intended this sampling revenue procedure to be the sole source for guidance on statistical sampling. Rev. Proc. 2012-20, however, imposes an additional requirement by stating that "sampling methodologies not described in Rev. Proc. 2011-42 are not permitted." Rev. Proc. 2011-42 says that a "sample or method not covered by this revenue procedure ... may be referred to a Statistical Sampling Coordinator for resolution or issue development."

Observation: Because most taxpayers likely have been following statistical sampling guidance published in Rev. Proc. 2011-42, this new guidance should not raise any issues. However, because other statistical methods also have been used and accepted by IRS Statistical Sampling Coordinators, the language in Rev. Proc. 2012-20 that "sampling methodologies not described in Rev. Proc. 2011-42 are not permitted" has created some uncertainty. This uncertainty may affect some taxpayers that intended to rely upon previous statistical samples for making adjustments that would bring them into compliance with the temporary regulations, as well as in new sampling-based adjustments. Discussions with IRS Chief Counsel have indicated that there was no intent to change practices that have been acceptable to the IRS Statistical Sampling Coordinators.

Other reporting requirements and considerations for the new methods

Where to file

As in the case of other automatic method changes related to depreciable property, a copy of Form 3115 for any of the six new changes should be filed with the IRS office in Ogden, UT, and not with the IRS National Office in Washington, DC.

Interaction with section 263A

In general, taxpayers may not file a method change if the item being changed is required to be capitalized under section 263A and the taxpayer does not properly capitalize that item under section 263A. Similar to other method changes provided for under Rev. Proc. 2011-14, taxpayers that wish to make any of the aforementioned methods changes (other than GAA elections) that are not properly accounting for the change item under section 263A may file a concurrent change to properly capitalize the costs under a UNICAP method.

Public utility property

A taxpayer that makes a change for public utility property (within the meaning of section 168(i)(10), or former section 167(l)(3)(A) in the case of leasehold improvements) under any of the six new automatic method changes described in Rev. Proc. 2012-20 must attach to its Form 3115 a statement that the taxpayer agrees to additional terms and conditions.

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