
WNTS Insight

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Accounting method changes under the tangible property regulations: deduction and capitalization of expenditures

Rev. Proc. 2012-19, released on March 7, provides the change in method of accounting procedures for taxpayers to comply with 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. 2012-20, providing rules for taxpayers making accounting method changes related to depreciation and dispositions under the temporary regulations. For in-depth analysis of Rev. Proc. 2012-20, see WNTS Insight, "[Accounting method changes under the tangible property regulations: dispositions of property](#)," 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.

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 accounting method changes reflect the methods of accounting described in the temporary regulations.

In general, the new automatic accounting method changes provided by Rev. Proc. 2012-19 contain similar procedural rules relating to section 481(a) adjustments, audit protection, scope limitations, and concurrent filing requirements. These items and specific repairs method changes are discussed in more detail below.

Specifically, Rev. Proc. 2012-19 modifies Rev. Proc. 2011-14 by obsoleting and removing the earlier automatic method change provisions relating to repairs, effective for tax years beginning on or after January 1, 2012.

Rev. Proc. 2012-19 further modifies Rev. Proc. 2011-14 by providing automatic method change procedures for the following method changes:

- Deducting repair and maintenance costs;
- Change to the regulatory accounting method;
- Deducting non-incidental materials and supplies when used or consumed;
- Deducting incidental materials and supplies when paid or incurred;
- Deducting non-incidental rotatable and temporary spare parts when disposed of;
- Change to the optional method for rotatable and temporary spare parts;
- Deducting dealer expenses that facilitate the sale of property;
- Deducting de minimis amounts (capitalization threshold);
- Deducting certain costs for investigating or pursuing the acquisition of real property, including employee compensation and overhead;
- Change to the safe harbor for routine maintenance on property other than buildings;
- Non-dealer expense to facilitate the sale of property;
- Capitalizing and depreciating acquisition or production costs; and
- Capitalizing and depreciating improvements to tangible property.

Section 481(a) adjustments

Rev. Proc. 2012-19 conforms to the section 481(a) requirements provided by the temporary regulations. Specifically, the repair regulations generally require a cumulative section 481(a) adjustment applicable to tax years beginning on or after January 1, 2012.

However, for certain items the repair regulations require a modified section 481(a), or "modified cut off," adjustment for amounts paid or incurred in tax years beginning

on or after January 1, 2012. The modified section 481(a) adjustment takes into account only amounts paid or incurred in tax years beginning on or after that date. Accordingly, a taxpayer's existing method of accounting for an item paid or incurred in tax years beginning prior to January 1, 2012, will not be disturbed, and only amounts paid or incurred with respect to the item in tax years beginning on or after January 1, 2012, will be subject to the new change in method of accounting.

Rev. Proc. 2012-19 does not modify the section 481(a) adjustment spread period general rules of Rev. Proc. 2011-14. Thus, a section 481(a) adjustment that is a reduction to taxable income is taken into account during the year of change, while a section 481(a) adjustment that is an increase to taxable income is taken into account over four tax years, beginning with the year of change.

Observation: Under the general requirement in the temporary regulations for a section 481(a) adjustment, taxpayers that currently use a more favorable accounting method for repairs than permitted under the repair regulations likely will have to give back some of the benefit. Likewise, taxpayers that currently use a less favorable method likely will be able to claim missed repair deductions. If a section 481(a) adjustment is required, then the cumulative effect -- including any section 481(a) adjustments from prior repairs method changes -- must be reflected in the adjustment. For example, any taxpayer that previously incurred expenses to repair or improve tangible property must conform all expenditures for prior years to the rules in the temporary regulations. In particular, taxpayers that performed a repairs study in the past likely will have to revisit those studies and analyze their past-year expenditures in accordance with the temporary regulations.

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. 2012-19 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 of 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. 2012-19 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.

Single application for two or more concurrent changes

In general, a taxpayer filing any of the changes in Rev. Proc. 2012-19 for the same tax year may include all such changes on a single application.

Observation: When filing a single Form 3115 for two or more concurrent accounting method changes, a taxpayer must provide the following for each change included on the single Form 3115:

- the item being changed;
- the present method for the item being changed;
- the proposed method for the item being changed; and
- the section 481(a) adjustment(s).

New automatic accounting method changes in Rev. Proc. 2012-19

As noted above, Rev. Proc. 2012-19 provides the procedures by which a taxpayer may obtain automatic consent to change the methods of accounting for several items. The following provides an analysis of the method changes addressed by Rev. Proc. 2012-19, and the related terms and conditions applicable to each change.

Deducting repair and maintenance costs

Rev. Proc. 2012-19 modifies the Appendix to Rev. Proc. 2011-14 by adding a new method change from capitalizing under section 263(a) amounts paid or incurred for tangible property to deducting these amounts as repair and maintenance costs under section 162. This particular method change also applies to a taxpayer that wishes to change its units of property (UOP) solely for purposes of determining whether amounts paid or incurred improve a UOP. A taxpayer may need to make either or both of these changes.

This accounting method change does not apply to a taxpayer that wishes to change its method of accounting for dispositions of depreciable property, including a change in the asset disposed of, for any tax year in which the repair allowance was made or for

any property subject to the repair allowance. Such method changes are made separately, as discussed below.

A taxpayer changing to this method of accounting must not include in the section 481(a) adjustment any amount attributable to property for which the taxpayer elected to apply the repair allowance.

Finally, a taxpayer changing its method of accounting under this new section must attach to its Form 3115 a schedule for the section 481(a) adjustment listing the adjustment amounts for each property classification (for example, 5-year property, 7-year property, or nonresidential real property).

Observation: Noticeably absent from this particular method change is a change to capitalize and depreciate amounts paid or incurred to improve a UOP. However, this method change is provided in a new, different section of the Appendix to Rev. Proc. 2011-14 that is described more fully below.

Other accounting method changes provided by Rev. Proc. 2012-19

| | Description of Change | Section 481(a) Adjustment vs. Modified Section 481(a) Adjustment | Special Terms and Conditions |
|---|---|--|---|
| 1 | Change to the regulatory accounting method | Cumulative section 481(a) adjustment | May not include dispositions for any property subject to a repair allowance election or any tangible property not subject to regulatory accounting rules. |
| 2 | Deducting non-incidental materials and supplies when used or consumed | Modified section 481(a) adjustment | Change does not apply to rotatable or temporary spare parts. |
| 3 | Deducting incidental materials and supplies when paid or incurred | Modified section 481(a) adjustment | None |
| 4 | Deducting non-incidental rotatable and temporary spare parts when disposed of | Modified section 481(a) adjustment | None |
| 5 | Change to the optional method for rotatable and temporary spare parts | Cumulative section 481(a) adjustment | None |
| 6 | Deducting dealer expenses that facilitate the sale of property | Cumulative section 481(a) adjustment | Change does not apply to liabilities incurred to facilitate the disposition of assets that constitute a trade or business. See Reg. sec. 1.263(a)-5(g). |

| | Description of Change | Section 481(a) Adjustment vs. Modified Section 481(a) Adjustment | Special Terms and Conditions |
|----|--|--|--|
| 7 | Deducting de minimis amounts (capitalization threshold) | Modified section 481(a) adjustment | This change does not apply to: (1) amounts paid for property that is or is intended to be included in inventory, (2) amounts paid for land, and (3) start-up expenditures. |
| 8 | Deducting certain costs for investigating or pursuing the acquisition of real property, including employee compensation and overhead | Modified section 481(a) adjustment | This change does not apply to start-up expenditures. |
| 9 | Change to the safe harbor for routine maintenance on property other than buildings | Cumulative section 481(a) adjustment | This change does not apply to a building or a structural component of a building. |
| 10 | Non-dealer expense to facilitate the sale of property | Cumulative section 481(a) adjustment | Change does not apply to liabilities incurred to facilitate the disposition of assets that constitute a trade or business. See Reg. sec. 1.263(a)-5(g). |
| 11 | Capitalizing and depreciating acquisition or production costs | Cumulative section 481(a) adjustment | None |
| 12 | Capitalizing and depreciating improvements to tangible property | Cumulative section 481(a) adjustment | <p>Change does not apply to a taxpayer that wants to change its method of accounting for dispositions of depreciable property or for any property subject to a repair allowance.</p> <p>A separate schedule must be attached to the Form 3115 for the section 481(a) adjustment listing the adjustment amount for each property classification (e.g., 5-year property, 7-year property).</p> <p>A taxpayer making this change must complete Form 3115, Schedule E, and attach it to the Form 3115.</p> |

Note: A taxpayer changing to use the optional method for rotatable and temporary spare parts must take into account a full section 481(a) adjustment. This is in contrast to the other changes for materials and supplies, including rotatable spare parts, which are implemented with a modified section 481(a) adjustment.

Observation: Rev. Proc. 2012-19 provides that a change in method of accounting does not unequivocally permit a current deduction. For example, a taxpayer with inventories may have to capitalize a portion of its repairs and maintenance expenses under section 263A and recover that amount through costs of goods sold.

Observation: Rev. Proc. 2012-19 now permits a taxpayer to automatically change its method of accounting to begin deducting incidental materials and supplies when paid or incurred. This type of method change previously could be made only with the advance consent of the IRS, that is, on a non-automatic basis.

Statistical sampling guidance

The appropriateness of statistical sampling is specifically covered with most method changes; however, the guidance is silent with respect to several areas. 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. The following table summarizes areas discussed in Rev. Proc. 2019-19 and shows where sampling is expressly permitted.

| | Method Changes | Is Sampling Addressed? |
|----|---|------------------------|
| 1 | Deducting repair and maintenance costs | Yes |
| 2 | Change to the regulatory accounting method | Yes |
| 3 | Deducting non-incidental materials and supplies when used or consumed | Yes |
| 4 | Deducting incidental materials and supplies when paid or incurred | Yes |
| 5 | Deducting non-incidental rotatable and temporary spare parts when disposed of | Yes |
| 6 | Change to the optional method for rotatable and temporary spare parts | Yes |
| 7 | Deducting dealer expenses that facilitate the sale of property | No |
| 8 | Deducting de minimis amounts (capitalization threshold) | No |
| 9 | Deducting certain costs for investigating or pursuing the acquisition of real property including employee compensation and overhead | No |
| 10 | Change to the safe harbor for routine maintenance on property other than buildings | Yes |
| 11 | Non-dealer expense to facilitate the sale of property | No |

| | Method Changes | Is Sampling Addressed? |
|----|---|------------------------|
| 12 | Capitalizing and depreciating acquisition or production costs | Yes |
| 13 | Capitalizing and depreciating improvements to tangible property | Yes |

When statistical sampling is used, Rev. Proc. 2012-19 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. 2012-19, 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 (and its predecessors in IRS field directives) in the numerous repairs studies performed prior to the issuance of the tangible regulations, 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. 2012-19 "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.

Observation: Previous repairs guidance limited to electric transmission and distribution property (Rev. Proc. 2011-43) provided a special extrapolation method allowing the results of a review of at least three years, including the year of change, to prior unreviewed periods. The extrapolated adjustment for these prior unreviewed periods is subject to a "haircut." Some taxpayers had anticipated that a similar approach might be provided for all taxpayers. While extrapolation is not discussed in Rev. Proc. 2012-19, the IRS is interested in receiving comments on whether such an approach should be provided, and if so, how it might work.

For prior coverage of Rev. Proc. 2011-42, see WNTS Insight, "[IRS allows taxpayers greater use of statistical sampling](#)," August 29, 2011.

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