

ADDRESSING HEAD ON THE FORM 3115 CONTROVERSY UNDER THE NEW REPAIR/CAPITALIZATION REGULATIONS

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Overview

In addressing the Treasury's new repair/capitalization regulations under Code Sections 164, 168 and 263, many practitioners overlooked that the regulations required affected taxpayers to file a change in the method of accounting method (Form 3115) unless exempted:

[E]xcept as otherwise stated, a change to comply with the final regulations is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. (Preamble to TD 9636 Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Personal Property)

While recently issued Rev. Proc. 2015-20 provides relief, the rules are complicated.

Chart of Several Significant Provisions – Election, Form 3115 or Both?

On February 2, 2015 the Treasury issued Rev. Proc. 2015-14, **mandating** a “no fee” Form 3115 to adopt most changes under the new capitalization/repair regulations, excluding only three election statements. Practitioners alarmed at the complexity to cross-review i) regulations, ii) taxpayer accounting and iii) Rev. Proc. 2015-14, for every client during 2014, raised public alarm resulting in the issuance of Rev. Proc. 2015-20, 2015-9 IRB __ - a “non-filing” option available only to qualified small taxpayers.

The result is a rather complicated process to decide whether or not a Form 3115 should be filed. We have prepared a chart and are discussing the rules to provide some guidance. In the chart, “*possible action required*” - means a Form 3115 is **not** required for **small taxpayers**. (See page 6 below.)

<u>Description Under Regulations</u>	<u>Actions Required</u>	<u>Sample Election on Return</u>
<u>1.162-3 Materials & Supplies</u> <u>Rotables</u> . Election to capitalize & depreciate retables.	<u>Limited Application</u> . Possible action required to file Form 3115 if it involves a change in the current practice. See Rev. Proc. 2014-17.	N/A use Form 3115 if not a “small taxpayer.” Simplified reporting for <i>qualified</i> small taxpayers (<\$10 M in gross receipts).
<u>Small wares</u> . Rev. Proc. 2002-12. Right to treat small wares as materials and supplies that are	<u>Limited Application</u> . Possible action required to Form 3115 if this is a change in policy. Most clients are	N/A use Form 3115 if not a small taxpayer.

not material.	probably already doing this.	
<p><u>1.162-4 Repairs</u></p> <p>Basic rule – deduction if not improvement, betterment. Cross-reference new 263(a)-3(n) election <u>must follow books & records.</u></p>	<p>Possible action required if this involves a change in policy. Rev. Proc. 2015-14 lists 11 areas. Does not apply to certain basic elections. File Form 3115, only if there is a “change” from prior returns (change #):</p> <ul style="list-style-type: none"> ● deducting non-incidental materials and supplies when first used. (186) ● deducting incidental materials and supplies when purchased. (187) ● deducting non-incidental rotatable or spare parts when disposed. (188) ● using the optional method for rotatables and spare parts. (189) ● what is deducted as repair or maintenance under 1.162-4, including a change to identify the unit of property under 1.263(a)(3)(e), or for a building, to identify the building structure or systems under 1.263(a)-3(e)(2). (184) ● what is capitalized as improvements to tangible property under 1.263(a)-3 (and depreciating such property), including a change to identify the unit of property under 1.263(a)(3)(e), or in the case of a building, to identify the building structure or systems under 1.263(a)-3(e)(2). (184) ● property dealer deducting sales commissions and facilitating costs (190) ● a non-dealer in property capitalizing commissions and sales costs (191) ● capitalizing the costs to acquire or produce tangible property (192). ● deducting failed real property acquisition or investigation costs (193) ● using the optional regulatory accounting method (e.g. utilities). <p>File Form 3115 in Ogden Utah before return filed. See “Basic Accounting</p>	<p>N/A use Form 3115 if not a small taxpayer.</p>

	Rules” Below”	
<p>1.263(a)-1(f) & 1.162-3(f) Small Purchases or Improvements - De-Minimis Exceptions</p> <p>Elect to deduct small capital purchases</p> <p>AFS – up to \$5,000 or <12 month life (AFS = audited, governmental or SEC financial statements)</p> <p>No AFS –\$500 or < 12 month life</p>	<p>Safe Harbor.</p> <p>No Form 3115 Required (not even if \$\$ amount of write-off allowed changes)</p> <p>Election required on return. Optional, not mandatory. Must elect annually on timely filed return. Must adopt <u>written</u> accounting policy at beginning of year– if have AFS; policy required, but need not be written, if no AFS.</p>	<p>Section 1.263(a)-1(f) DeMinimis Safe Harbor Election</p> <p>Taxpayer Name</p> <p>Address</p> <p>Taxpayer Identification #</p> <p>Taxpayer is making the <i>de minimis</i> safe harbor election under §1.263(a)-1(f)</p>
<p>1.163-3(f) Materials & Supplies.</p> <p>Election to deduct material & supply purchase items < \$200</p>	<p>Safe Harbor.</p> <p>No Form 3115 Required. Not Mandatory, BUT, must apply if elect De-Minimis on materials & supplies.</p>	<p>N/A use Form 3115 if not a small taxpayer.</p>
<p>1.263(a)-3 Routine Maintenance Safe Harbor</p>	<p>Possible action required if it is a change in accounting method.</p>	<p>N/A use Form 3115 if not a small taxpayer.</p>
<p>1.263(a)(3) Optional Regulatory Accounting Method</p>	<p>I am not covering. I don’t have these regulatory clients –utilities, energy, etc.</p>	<p>N/A use Form 3115 if not a small taxpayer.</p>
<p>Basic Accounting Rules (intended to restate existing law)</p> <p>1.263(a)-1(a). Capitalize amounts paid to improve, better, restore or make good property.</p> <p>1.263(a)-1(b) Comply with 263A</p> <p>1.263(a)-1(e) Selling costs reduce amount realized in taxable year of sale. If not sold, but asset part of trade or business, can write-off. [Capitalize if convert asset to personal use if not sold.]</p> <p>1.263(a)-2. Acquisition Costs for Tangible Property</p> <p>1.263(a)-2(d). Must capitalize amounts to acquire/produce</p>	<p>Possible action required if a change in accounting method. See list at 1.162-4 at beginning. The most controversial are the items in bold in list above. IRS may argue “unit of property” concept did not exist prior to the regulations.</p> <p>Change numbers, listed under pp. 209-210 of Rev. Proc. 2015-13 include the “Unit of Property” Change Code:</p> <p>If final regulations: 184</p> <p>If temporary regulations: 162</p> <p>All Form 3115 filings under the applicable revenue procedures allow simplified reporting for qualified small taxpayers (<\$10 M in gross receipts).</p>	<p>N/A use Form 3115 if not a small taxpayer.</p>

<p>tangible property.</p> <p>Ameliorating a pre-existing condition, existing at acquisition is a betterment. (Replaces I part the rehabilitation doctrine)</p> <p>If an addition or increase in a particular factor cannot be measured in the context of a specific type of property, then the factor is not relevant to whether there has been a betterment to the property.</p> <p>A building “area” refreshment or limited remodel is not a betterment.</p>		
<p>New Concepts – Unit of Property 1.263(a)-3 1.263(a)-3(e) Leasehold Improvements Material Component (Replacing Plan of Rehabilitation Doctrine)</p>	<p>Possible action required if a change in accounting method for your client.</p>	<p>N/A – Use Form 3115 if not a small taxpayer.</p>
<p><u>Removal Costs</u> 1.263(a)-3. Costs to remove portion of property, including entire unit of property is deductible. (i.e., not just membrane, but entire roof tear-off). “not required to be capitalized” <u>Late Partial Disposition Election:</u> See 1.168(i)-8 Partial Disposition Election Below (annual election).</p>	<p>Rev. Proc. 2015-14, 2015-5 IRB__ Rev. Proc. 2014-17 1.263(a)-3(e) & (f). Unit of Property Defined – partial dispositions. 6.33. Change 196. <u>Late</u> Partial Disposition Election (2012 or 2013-year) Form 3115 – file in Ogden and then on original return, including extensions. Qualified small taxpayer simplified reporting is available on all options. 1.168(i)-8. Partial Dispositions. 6.35 Change 199 Form 3115 – file in Ogden and then on</p>	<p>N/A – Use Form 3115 if not a small taxpayer.</p>

	original return, including extensions. Simplified reporting may be available.	
<p>Existing use of General Mass Asset Accounts for simplified depreciation. (verses specific identification/depreciation of each separate new asset.)</p> <p>New Partial Disposition Under Mass Asset Account: – can remove any individual asset disposed.</p> <p>Individuated Assets. Can follow-partial removal above.</p>	<p>Optional. May decide to revoke general asset account election on personal property.</p> <p>Rev. Proc. 2014-17. 6.34 (Change 196)</p> <p>Form 3115 required to abandon general asset account. <i>Benefit to abandonment is right to look at individual assets for partial dispositions. Can still elect partial removal of “whole asset” under new rules.</i></p> <p>Late election for</p> <ul style="list-style-type: none"> ● gain/loss on disposition of all assets in general asset account ● gain/loss on partial disposition of asset in general asset account <p>6.32. Change 180.</p> <p>Late Election for</p> <p>Form 3115 – file in Ogden and then on original return, including extensions. Small taxpayer simplified reporting.</p>	N/A – Use Form 3115 if not a small taxpayer.
<p>1.263(a)(3)(h) Small Building – Repairs Safe Harbor</p> <ul style="list-style-type: none"> ● Qualifying Small Taxpayer (ave annual GR < \$10M) ● Cost of building < \$1 M ● Total “amount spent on building” is both < \$10K and < 2% unadjusted basis. ● Must include amounts spent, even if under de minimis safe harbor 	<p>May file elect on the return. Elect on a building-by-building basis</p> <p>Must make on a timely filed original return, including extensions. May not revoke an election.</p> <p>Made by S Corporation or Partnership at entity level.</p> <p>May not be made through a form 3115 or, by an amended return (without the Commissioner’s consent)</p>	<p>Statement on Return:</p> <p>Section 1.263(a)-3(h) Safe Harbor Election for Qualified Small Taxpayers.</p> <p>Name</p> <p>Address</p> <p>Identification Number</p> <p>Identify Each Building</p> <p>While not required by regs: add</p> <p><i>Taxpayer is making the §1.263(a)-3(h) safe harbor election for qualified small taxpayers.</i></p> <p>.</p>
1.263(a)-3(i) Routine Maintenance	No return election available. This is a	N/A – Use Form 3115 if not a

<ul style="list-style-type: none"> • Must expect to perform the service more than once within a 10-year period 	<p>procedural safe harbor.</p> <p>Therefore, Form 3115 <i>may</i> be required if it involves a change in the accounting method.</p> <p>If taxpayer <u>already</u> took this position, or had no position, then Form 3115 may not be required.</p>	<p>small taxpayer.</p>
<p>1.262(a)-3(n). Election to Capitalize All Repairs</p> <p>May elect to capitalize <u>all</u> repairs and maintenance</p>	<p>May elect on a timely filed original return. May not revoke an election.</p> <p>Made by S Corporation or Partnership at entity level.</p> <p>May not be made through a form 3115 or, by an amended return (without the Commissioner’s consent)</p>	<p>Section 1.263(a)-3(n) Election</p> <p>Name</p> <p>Address</p> <p>Identification Number</p> <p>Taxpayer is making the election to capitalize repair and maintenance costs under Section 1.263(a)-3(n).</p>
<p>Small Taxpayer Exception</p> <p>Rev. Proc. 2015-20</p>	<p>May opt out of filing Form 3115 for each separate trade/business of a “small taxpayer” – covers:</p> <ul style="list-style-type: none"> • Beginning total assets < \$10 million • Qualified small taxpayer (1.263(a)-3(h) - < \$10 million gross receipts (with reference to separate trade/business.) <p>No safe harbor from audit if used impermissible method in prior year.</p>	<p>No filing with the IRS. Must make any Section 481 adjustment. Likely \$0.</p>
<p>1.168(i)-8(d). Partial Disposition Election</p> <p>Election to write-off partial disposition</p>	<p>Elect to dispose a portion of an asset.</p> <p>May not make the election by Form 3115. (Partially conflicting, see above.)</p> <p>Identify portion disposed and make disposition by reporting gain, loss or other deduction on return.</p>	<p>No special election language required. .</p>

Discussion

Form 3115 Required? Treasury’s position is that generally a Form 3115 should be filed if the capitalization/repair regulations represents a change in accounting method for taxpayers, but for three

elective exemptions:

- De-minimis improvements deduction elections (1.263(a)-1(f) election)
- Election to capitalize repairs and maintenance (1.263(a)-1(n) election)
- Election for qualified small taxpayer to expense all repairs and improvements on small buildings (<\$1 million unadjusted basis); if total expenses are both < \$10,000 and 2% unadjusted basis. (1.263(a)-1(h) election.
- Election to take a partial disposition under 1.168(i)-8 of a component of MACRS property. (Warning: election requires capitalization of the replacement.)

However, Rev. Proc. 2015-20, exempts **small taxpayers**; they may opt out of filing Form 3115. The small taxpayer exemption covers any separate trade or business that has i) less than \$10 million total assets at the first day of the tax year or ii) average annual gross receipts are \$10 million or less (following §1.263(a)-3(h)(3)).

In addition, while not identified, some taxpayers (i.e., new businesses), may claim that their accounting method has not changed or that they have not yet adopted an accounting method affected by the new regulations.

Under Rev. Proc. 2015-20, most taxpayers will likely meet the small taxpayer exception and need not file a Form 3115 to follow the new capitalization/repair regulations; however, the procedure still requires a Section 481 adjustment be made. Moreover, the exemption for **small taxpayers** covers more taxpayers than the simplified Form 3115 reporting for “qualified small taxpayers” (which only covers those with less than \$10 million in average gross receipts, not businesses with less than \$10 million in beginning assets.)

Given the exemption from Form 3115 under Rev. Proc. 2015-20, should a Form 3115 be filed? The answer is it depends. First, it offers “audit protection” from the IRS making audit adjustments to prior years based on disallowing a prior year accounting method. Second, if not meeting the small taxpayer exemption, a Form 3115 may be required to assure the benefits of the new law. For example:

- Taxpayers may want to claim deductions allowed for partial dispositions on assets held in a mass group asset account; they must elect out of general mass-asset accounts. A Form 3115 would help on documentation.
- On a partial replacement deduction (not considered a major component), a Form 3115 would document the change in accounting method.

Other examples to which a Form 3115 might be helpful on a protective basis only would include the following:

- Change #184. For those adopting the **routine maintenance safe harbor** – recurring expenses more than once each 10 years) Or for those adopting the unit of property concept to permit deductions on certain partial replacements within a major structural system.

- Change #186. For those adopting a policy to **deduct amounts paid for non-incidentals materials** and supplies that might *normally be capitalized*.
- Change #187. For those adopting a policy to **deduct amounts paid for non-incidentals materials and supplies** that might *normally be inventoried*.

In addition, a Form 3115 may be considered under Rev. Proc. 2014-17 and Rev. Proc. 2014-54, issued last year, both which cover fairly narrow situations.

In addition, a Form 3115 should be considered to gain a safe harbor if there is concern as to an audit examination challenging a prior year for an improper accounting method. The Form 3115, if filed before audit contact for the 2014-year provides some prior year audit protection. (Rev. Proc. 2014-13, 2015-5 I.R.B.____.) Accordingly, it may be a front door method to come into compliance on a prior year method not permitted by the Service.

Section 481(a) Adjustment. Whether or not a Form 3115 is filed, the Service's position is that the making of an accounting change requires a Section 481 adjustment. For example, a prior year replacement of a roof membrane, previously capitalized (and partly depreciated), may be written off.

Partial Disposition Election. In adopting certain partial replacements as repairs, caution is urged to not take the partial disposition election. While a disposition election under Section 1.168(i)-8. (i.e. one of four HVAC systems is replaced) may be opted, it will override and disallow the taxpayer from treating the replacement as an expense. Rather the replacement property would then have to be capitalized under Treas. Reg. §1.263(a)-3(k)(1)(i). This is illustrated at Treas. Reg. §1.168(i)(8)(i), Example 3.

Filed 3115. Rev. Proc. 2015-20 in its preamble clarifies that they did intend a full adjustment to account for prior years. If a change occurs, the adjustment must be made to account "*for how taxpayer treated the items being changed in prior years to avoid duplication of deductions or omission of income.*" However, Section 481 more likely will involve a reduction to 2014-year income. For example, a prior year capitalized roof membrane replacement, under a Section 481 adjustment may allow a write-off of the unamortized replacement in 2014 if a Form 3115 is filed.

For taxpayers who choose or are required to file a Form 3115, a Section 481 amount must be stated. If the Section 481 adjustment will be a reduction, the Service may not challenge marking the amount as "\$0", although it has made no official statement about that.

No Filed Form 3115. For small taxpayers who do not file Form 3115, the regulations provide that any adjustment under Section 2014 would solely be for 2014-year or prospectively. For most this means that there would probably be a \$0 adjustment amount – no amount would then be indicated on the return.

Where no Form 3115 is filed, the prior years "do not receive audit protection under section 8.01 of Rev. Proc. 2015-13 (or any successor)..." (Rev. Proc. 2014-20) While an uncommon adjustment, if no Form 3115 is filed, an auditor may assert a change of accounting method for an audit year beginning prior to January 1, 2014.

Given the extensive relief granted by Rev. Proc. 2015-20, few challenges to the Form 3115 filing requirement are expected. Conceivably, there will be some challenges. For example, the provisions involving unit of property as relate to building systems arguably are not a “change” in law but an interpretation of existing case law pouring an old wine in a new wine sack. In addition, the CAMICO warning now seems outdated. However, given that issue of filing is far more complex, practitioners may wish to consult with tax counsel who is familiar with these procedures and rulings.

Lastly, if not filed with the 2014-year return, it may not be the end of the world as these rulings would allow elections to be made in the 2015-year. More often than not, the IRS as a matter of practice provides more leniency in the first year that returns are subject to new regulations not involving a statutory change.

Form 3115

Basics. While as explained above, qualified small taxpayers – as defined above, may elect out, other qualified small taxpayers may file a simplified “no fee” Form 3115 (i.e., partly filled out.) For those required to file, or not electing out of filing, to be effective for the 2014-year, the Form 3115 must be filed in Ogden, Utah - separately - before the year-end return for 2014. A copy should be attached to the 2014-year return.

Simplified Filing. The Service is allowing one Form 3115 to cover several changes. In addition, a qualified small taxpayer whose average annual gross receipts, as determined under § 1.263(a)-3(h)(3) for the three preceding taxable years, is less than or equal to \$10,000,000, may make a simplified filing. Here is a **sample** of what is required for under one of the elections (i.e., the rules differ by election.)

A qualifying taxpayer is required to complete only the following information on Form 3115:

- (A) The identification section of page 1 (above Part I);*
- (B) The signature section at the bottom of page 1;*
- (C) Part I, line 1(a);*
- (D) Part II, all lines except lines 11, 13, 14, 15, and 17;*
- (E) Part II, line 13, if the change is to depreciating property;*
- (F) Part IV, lines 25 and 26; and*
- (G) Schedule E, if applicable.*

Completing Form 3115. In completing the Form 3115, while there are a number of nuances, even under the simplified reporting. The more limited situations are covered under Rev. Proc. 2014-17 and Rev. Proc. 2014-54, which apply to just a few taxpayers. Broader coverage is under Rev. Proc. 2015-14, from pages 199-210, covering most of the information needed.

In reviewing any of these procedures, there is a pattern to each covered automatic election to be filed with Ogden before the 2014-year return is filed.

Where to File. If Form 3115 is filed, the mailing address is as follows:

INTERNAL REVENUE SERVICE
Ogden, UT 84201

Or,

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

Rev. Proc. 2014-54.

Lastly, while not part of the general discussion of the controversy, for those who elected as of January 1, 2012, Rev. Proc. 2014-54, 2014-2 CB _____. [CCH SFTR Par. 46,429, covers if there will be a change January 1, 2014. It is expected only to be of interest to about 1,700 taxpayers in the entire United States. The following is a summary of just a few of those in that category which modifies and is used to illustrate the effect of Section 481 adjustments.

1. Section 3. This section covers an early transition covering general asset accounts.
 - A. Early Transition Year (Late Election) (2012 or 2013)
 - i. Includes change to comply with:
 - (1) General Asset Accounts under 1.168(i)-1;
 - (2) (i)-7 and (i)-7
 - (3) Partial/prior MACRS asset dispos under 1.168(i)-8.
 - ii. Ignore assets acquired during a year-ending before January 1, 2014. File amended return for open years.
 - iii. Section 3 is for transition period changes (1/1/2012-12/31/2013).
 - iv. Does not apply to
 - (1) property before period or after period,
 - (2) to property subject to amortization,
 - (3) to general asset account election property,
 - (4) to multiple buildings, condos, coops treated as one property or that will be treated as one single property, or
 - (5) to property required upon demolition to be capitalized.
 - v. The late election must be made for the transition year.

- vi. Form 3115 must be filed with Oden, Utah (not national office).
 - vii. File no later than the date the return is filed with the IRS for the year of change.
- B. 6.33 Late Partial Disposition Election.
- i. On a capitalized partial replacement (new roof capitalized), this is the right to write-off the existing component replaced (the old roof).
 - ii. If average Gross Receipts Under \$10 Million, then on Form 3115, fill out only
 - (1) Identification (page 1, above Part I)
 - (2) Part II, except 11, 13, 14, 15 and 17 are blank
 - (3) Part IV, lines 25 and 26; and
 - (4) Schedule E, line 3
 - iii. If the change is made:
 - (1) Apply 1.168(i)-8((h)(1) and (3) (or proposed)
 - (2) Classify the replacement in the same asset class if whole asset is under class 00.11 to 00.4 of Rev. Proc. 87-56, 1987-2 CB 674.
 - (3) Deem disposed portion as sold to recognize gain/loss (this is not “accelerated depreciation”); stop taking depreciation on disposed portion.
 - (4) While it does not make sense, the guidance says that if in a year prior to the year of change there was recognized gain/loss from disposition, that it must be recognized [again?] under the regulations.
 - iv. Form 3115 must be filed with Oden, Utah (not national office) no later than the due date for the year of change.
 - v. The Change Designation Number is “196”
 - vi. Patrick Clinton (202) 317-7005 is the contact person at Chief Counsel’s Office.

Example – Summarized – Straight from Rev. Proc. 2014-54: Roof Replacement in 2010-Year.

During the 2000-year, Y, a calendar year taxpayer, acquired and placed in service a building and its structural components. Y replaced the entire roof in 2010. On its federal income tax return ended December 31, 2010, Y did not recognize a loss on retirement. Y also capitalized the cost of a replacement roof effective June 2010. The original roof had a 2010-year adjusted basis of \$11,000; it has since had accumulated depreciation of \$1,000 (arising after its retirement.)

Y filed with its federal income tax return for December 31, 2011 to treat the building as

an asset and each structural component of the building as a separate asset for disposition purposes. The amount of the negative Section 481 adjustment is \$10,000 – through December 31, 2011.

Y also decides to make a partial disposition election. Y may file Form 3115 with its 2014 federal income tax return to make a partial disposition election for the original roof and recognize a loss.

C. 6.44 Revocation of General Asset Account Election (in connection with prior partial disposition election.)

- i. Similar to above
- ii. Designation is 197 (see Par (10))

Example

Z has same situation as Y, except Z claimed \$500 depreciation on the original roof for the 2012-year.

In addition, when in 2012, Z filed Form 3115 to make a late general account election in 2012 to include the building placed in service in 2000 in one general asset account and the replacement roof in a separate general asset account. A late qualifying disposition election was made, where a \$10,000 loss was reported on the 2012-year return.

For the 2014-year, Z files Form 3115 to revoke the general account election and to treat the replacement roof as a separate asset for disposition purposes. The Section 481 adjustment from the prior year is reversed, but resulted in a \$9,500 net positive Section 481 adjustment.

D. 6.37. Change to/from Multiple Asset Accounts; or on Multiple Asset Accounts to using FIFO, modified FIFO or specific identification for dispositions. I am not discussing this. (Change Number 200)

E. 6.38. Disposition of Building.

Same as above, except \$500 in depreciation is claimed in 2012 and 2013–each year.

Y Filed Form 3115, claiming to treat the building as an asset and each structural component as a separate asset for the year ended December 31, 2012. A Section 481 adjustment of a \$10,000 amount was claimed.

“Because Y is not making a late partial disposition election for the original roof,” Y does not recognize the net loss \$10,000 upon the retirement of the original roof and must make a \$9,000 net positive adjustment.