Correcting for Failure to Take Depreciation

James R. Hasselback

I. Introduction to Changing the Depreciation Method

A. The magic words in depreciation – allowed or allowable

1. Allowed – If the taxpayer claimed a higher deduction than was allowable and that deduction was allowed for tax purposes (i.e., actually deducted on the taxpayer's return), the basis reduction is that higher allowed amount.

2. Allowable – If a taxpayer takes no depreciation, then the amount allowable is the amount allowable under the straight-line method. Meaning the basis of the asset must be reduced by the greater of the depreciation actually taken or the amount that is allowable under the depreciation rules.

B. If in the past years a taxpayer mistakenly claimed less than the permitted amount of depreciation on property used in business, any action taken to correct the mistake is a change in accounting method for which IRS permission is required.

C. The IRS, in Rev. Proc. 2018-31, says it will automatically consent to such a change as long as the taxpayer switches to an accounting method that is permissible for the business.

D. An adjustment for previously omitted depreciation may be taken on the tax return for the year of the change.

E. A taxpayer changing a method of accounting pursuant to this revenue procedure must complete and file an application in duplicate, using Form 3115.

F. File Form 3115, Application for Change in Accounting Method, must be filed by the due date of the tax return, including extensions.

G. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change, and a copy (with signature) of the application must be filed with the Odgen, Utah office no earlier than the first day of the year of change and no later than when the original is filed with the federal income tax return for the year of change [Rev. Proc. 2002-9 Section 6.02(a)].

1. For duplicate Forms 3115 that are mailed, the address is: Internal Revenue Service Ogden, UT 84201, M/S 6111. a)For duplicate Forms 3115 that are delivered by private delivery service, the address is: Internal Revenue Service 1973 N. Rulon White Blvd. Ogden, UT 84201 Attn: M/S 6111. For duplicate Forms 3115 that are delivered by facsimile, the number is (844) 249-8134. Delivery by encrypted electronic mail is not available for automatic change requests.

H. A user fee is not required for an application filed under this revenue procedure. Except for a receipt given at the courier's desk, the receipt of an application filed under this revenue procedure will not be acknowledged.

I. Section 481(a) Adjustment

   1. Because the adjusted basis of the property is changed as a result of a method change, items are duplicated or omitted. Accordingly, this change is made with a Section 481(a) adjustment. This adjustment may result in either a negative Section 481(a) adjustment (a decrease in taxable income) or a positive Section 481(a) adjustment (an increase in taxable income) and may be a different amount for regular tax, alternative minimum tax, and adjusted current earnings purposes. This Section 481(a) adjustment equals the difference between the total amount of depreciation taken into account in computing taxable income for the property under the taxpayer's present method of accounting and the total amount of depreciation allowable for the property under the taxpayer's proposed method of accounting for open and closed years prior to the year of change. However, the amount of the Section 481(a) adjustment must be adjusted to account for the proper amount of the depreciation allowable that is required to be capitalized under any provision of the Code (for example, Section 263A) at the beginning of the year of change.

J. The Sec. 481(a) adjustment period for positive adjustments is four taxable years.

   1. The IRS has reduced the four-year spread for negative adjustments to a single year, effective for tax years ending on or after December 31, 2001 [Rev. Proc. 2002-19].

II. Impermissible to permissible method of accounting for depreciation or amortization

A. This change applies to a taxpayer that wants to change from an impermissible to a permissible method of accounting for depreciation or amortization for any item of depreciable or amortizable property under the taxpayer's present or proposed method of accounting;

B. Requirements for Change of Method

1. The taxpayer must have used the impermissible method of accounting in at least two taxable years immediately preceding the year of change;

    a. Failure to take depreciation for just the preceding tax year is fixed by filing an amended return.

2. The taxpayer is making a change in method of accounting under §1.446-1(e)(2)(ii)(d);

3. Depreciation is determined under §56(a)(1), §56(g)(4)(A), §167, §168, §197, §1400I, or §1400L(c), or under any additional first year depreciation deduction provision of the Code (for example, §168(k), §168(l), §1400L(b), or §1400N(d)); and

4. That is owned by the taxpayer at the beginning of the year of change.

    a. Example, The taxpayer purchased a 15-year asset in 2015. The taxpayer sold the asset in June of 2024. The asset would qualify, as the asset was held at the beginning of 2024 for a 2024 change of method.

5. Remember that this is a change of accounting method, not an amended return. As such we are able to correct all prior year's depreciation not taken, not just the three previous years.

C. Permissible Method of Accounting for Depreciation

1. A taxpayer must change to a permissible method of accounting for depreciation for the item of depreciable or amortizable property. The permissible method of accounting is the same method that determines the depreciation allowable for the item of property.

D. Statements Required

1. A taxpayer (including a qualified small taxpayer) must provide the following statements, if applicable, and attach them to the completed Form 3115:

    a. A detailed description of the present and proposed methods of accounting. A general description of these methods of accounting is unacceptable (for example, MACRS to MACRS, erroneous method to proper method, claiming less than the depreciation allowable to claiming the depreciation allowable);

b. To the extent not provided elsewhere on the Form 3115, a statement describing the taxpayer's business or income-producing activities. Also, if the taxpayer has more than one business or income-producing activity, a statement describing the taxpayer's business or income-producing activity in which the item of property at issue is primarily used by the taxpayer;

c. To the extent not provided elsewhere on the Form 3115, a statement of the facts and law supporting the proposed method of accounting, new classification of the item of property, and new asset class in, as appropriate, Rev. Proc. 87-56 or Rev. Proc. 83-35. If the taxpayer is the owner and lessor of the item of property at issue, the statement of the facts and law supporting the new asset class also must describe the business or income-producing activity in which that item of property is primarily used by the lessee;

d. To the extent not provided elsewhere on the Form 3115, a statement identifying the year in which the item of property was placed in service by the taxpayer;

e. Special rules apply to public utility property.

E. Reduced Filing Requirement for Qualified Small Taxpayers

1. In general. A qualified small taxpayer is required to complete only the following information on Form 3115 (Rev. December 2018) to make this change:

a. The identification section of page 1 (above Part I);
b. The signature section at the bottom of page 1;
c. Part I;
d. Part II, all lines except lines 13, 15b, 16c, 17, and 19;
e. Part IV, all lines except line 25; and
f. Schedule E.

F. Basis Adjustment

1. As of the beginning of the year of change, the basis of depreciable property must reflect the reductions required by Section 1016(a)(2) for the depreciation allowable for the property.

2. Example. A taxpayer purchases a 7-year asset in 2019 for $20,000. The taxpayer failed to take depreciation on the asset. Taxpayer does a change of accounting method to pick up previous depreciation. The taxpayer will take a deduction in 2024 for $12,938; the depreciation for 2019-2023. The asset will have a $7,028 basis at the beginning of 2024; take regular depreciation for 2024.

G. Concurrent Automatic Change

1. A taxpayer making this change for more than one asset for the same year of change should file a single Form 3115 for all such assets and provide a single net Section 481(a) adjustment for all the changes included in that Form 3115. If one or more of the changes in that single Form 3115 generate a negative Section 481(a) adjustment and other changes in that same Form 3115 generate a positive Section 481(a) adjustment, the taxpayer may provide a single negative Section 481(a) adjustment for all the changes that are included in that Form 3115 generating such adjustment and a single positive Section 481(a) adjustment for all the changes that are included in that Form 3115 generating such adjustment. For example, a taxpayer files a single Form 3115 to change the depreciation methods, recovery periods, and/or conventions under Section 168(a) resulting from the reclassification of two computers from nonresidential real property to 5-year property, one office desk from nonresidential real property to 7-year property, and two office desks from 5-year property to 7-year property.

2. On that Form 3115, the taxpayer must provide either (i) a single net Section 481(a) adjustment that covers all the changes resulting from all of these reclassifications, or (ii) a single negative Section 481(a) adjustment that covers the changes resulting from the reclassifications of the two computers and one office desk from nonresidential real property to 5-year property and 7-year property, respectively, and a single positive Section 481(a) adjustment that covers the changes resulting from the reclassifications of the two office desks from 5-year property to 7-year property.

H. Designated Automatic Accounting Method Change Number

1. The designated automatic accounting method change number for a change is "7."

III. Impermissible to Permissible Method of Accounting for Depreciation or Amortization for Disposed Depreciable or Amortizable Property

A. What if the asset purchased in 2019 was sold in 2022?

B. Description of change

1. This change applies to a taxpayer that wants to make the change in method of accounting for depreciation or amortization (depreciation) provided under section 3 of Rev. Proc. 2007-16, 2007-1 C.B. 358, for an item of depreciable or amortizable property that has been disposed of by the taxpayer. Section 3 of Rev. Proc. 2007-16 allows a taxpayer to make a change in method of accounting for depreciation for the disposed property if the taxpayer used an impermissible method of accounting for depreciation for the property under which the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable, in the year of change or any prior taxable year.

C. Applicability

1. In general, this change of accounting method applies to a taxpayer that is changing from an impermissible method of accounting for depreciation to a permissible method of accounting for depreciation for any item of depreciable or amortizable property subject to §§167, 168, 197, 1400I, or §1400L(c), to former §168, or to any additional first year depreciation deduction provision of the Code (for example, §168(k), §168(l), §1400L(b), or §1400N(d)):

    a. That has been disposed of by the taxpayer during the year of change (the year the asset was disposed of by the taxpayer); and

    b. For which the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable (hereinafter, both are referred to as "claimed less than the depreciation allowable"), in the year of change or any prior taxable year.

2. Manner of Making the Change

    a. Change made on an original return for the year of change. This change may be made on a taxpayer's timely filed (including any extension) original federal tax return for the year of change, provided the taxpayer files the original Form 3115 in accordance with section 6.03(1)(a) of Rev. Proc. 2015-13, 2015-5 I.R.B. 419.

b. Change made on an amended return for the year of change. This change may also be made on an amended federal tax return for the year of change, provided:

   (1) The taxpayer files the original Form 3115 with the taxpayer's amended federal tax return for the year of change prior to the expiration of the period of limitation for assessment under Section 6501(a) for the taxable year in which the item of depreciable or amortizable property was disposed of by the taxpayer; and

   (2) The taxpayer's amended federal tax return for the year of change includes the adjustments to taxable income and any collateral adjustments to taxable income or tax liability (for example, adjustments to the amount or character of the gain or loss of the disposed depreciable or amortizable property) resulting from the change in method of accounting for depreciation made by the taxpayer.

3. Year of Change

   a. The year of change for this change is the taxable year in which the item of depreciable or amortizable property was disposed of by the taxpayer.

4. Filing Requirements

   a. A taxpayer making this change must attach the original Form 3115 to the taxpayer's timely filed amended federal tax return for the year of change and must file the required copy (with signature) of the Form 3115 with the IRS in Ogden, UT, no later than when the original Form 3115 is filed with the amended federal tax return for the year of change.

   b. Reduced filing requirement for qualified small taxpayers. A qualified small taxpayer is required to complete only the following information on Form 3115 (Rev. December 2018) to make this change:

   (1) The identification section of page 1 (above Part I);
   (2) The signature section at the bottom of page 1;
   (3) Part I;
   (4) Part II, all lines except lines 13, 15b, 16, 17, and 19;
   (5) Part IV, all lines except line 25; and
   (6) Schedule E.

5. Section 481(a) Adjustment Period

   a. A taxpayer must take the entire Section 481(a) adjustment into account in computing taxable income for the year of change.

6. Concurrent Automatic Change

    a. A taxpayer making this change for more than one asset for the same year of change should file a single Form 3115 for all such assets.

7. Designated Automatic Accounting Method Change Number

    a. The designated automatic accounting method change number for a change is “107.”

8. Gain or Loss on Sale is Probably Incorrect But keep in mind that if a taxpayer has failed to take depreciation, they probably did not reduce the basis of the asset by the depreciation not taken when the asset was sold. Thus, the loss is probably overstated or the gain understated on the sale. The adjustment to the gain or loss will equal the depreciation acquired through the change of accounting method.

9. What if the asset purchased in 2019 was sold in 2020? We would not be able to pick up the missed depreciation. We would need to file a change of accounting method and attach it to an amended 2020 income tax return. The 2020 income tax return is closed under the three-year statute of limitations.

D. Taxpayer has not Adopted a Method of Accounting for the Item of Property

1. A taxpayer does not satisfy a change from an impermissible to a permissible method of accounting when the item of property is placed in service by the taxpayer in the taxable year immediately preceding the year of change (“1-year depreciable property”). The taxpayer may change from the impermissible method of determining depreciation to the permissible method of determining depreciation for the 1-year depreciable property by filing a Form 3115 for this change, provided the Section 481(a) adjustment reported on the Form 3115 includes the amount of any adjustment that is attributable to all property (including the 1-year depreciable property) subject to the Form 3115. Alternatively, the taxpayer may change from the impermissible method of determining depreciation to the permissible method of determining depreciation for a 1-year depreciable property by filing an amended federal tax return for the property's placed-in-service year prior to the date the taxpayer files its federal tax return for the taxable year succeeding the placed-in-service year.

IV. Link for a filled-in Form 3115 by National Association of Tax Professionals

https://www.jrhasselback.com/blog/2019Form3115.pdf