Windfall Deductions from Changing Depreciation

Francine J. Lipman
James E. Williamson

Available at: https://works.bepress.com/francine_lipman/20/
WINDFALL DEDUCTIONS FROM CHANGING DEPRECIATION

by Francine J. Lipman, LLM, CPA, and James E. Williamson, PhD, CPA

A recent IRS revenue procedure may create an opportunity for windfall tax deductions for real estate managers and owners who have not realized all the depreciation benefits allowed by the tax laws. As described briefly in the July/August 1996 issue of JPM, Revenue Procedure 96-31, 1996-20 I.R.B. 1, permits taxpayers who have claimed less than the allowable depreciation in prior tax years to make an automatic change in their method of accounting for depreciation. This new revenue procedure not only allows an automatic change from an impermissible depreciation method or life to a permissible method or life, but also allows the taxpayer to take a deduction of the entire amount of the difference between the depreciation originally claimed and the amount allowable under an impermissible depreciation method or life.

When a taxpayer makes the automatic change in his or her depreciation method, not only is the deduction of catch-up depreciation allowable, it is required under Section 481(a) of the Internal Revenue Code. This one-time adjustment is necessary to prevent amounts from being omitted or duplicated when taxable income in the current year is computed utilizing a method of accounting different from the method used to compute taxable income in the preceding tax years.

To claim this windfall, catch-up depreciation, taxpayers must file IRS Form 3115 (Application for Change in Accounting Method) within the first 180 days of the tax year in which they wish to make the change. Because the new revenue procedure was not issued until May 13, 1996, there was little time available to make the change for 1996. However, those taxpayers who missed the 180-day deadline may request the change for 1997 or for subsequent tax years. In addition, a taxpayer has the option to either make the automatic change under the new revenue procedure or request permission (not automatic) to make the change under Revenue Procedure 92-20, 1992-1 C.B. 685 (or any successor).

Scope of the New Procedure

With some exceptions, this new revenue procedure applies to any taxpayer changing from an impermissible method of accounting to a permissible method of accounting for any item of property that is subject to depreciation or certain intangible property subject to amortization; was held by the taxpayer at the beginning of the year of the change; and, under the taxpayer’s present method of accounting, has not claimed any depreciation allowance or has claimed less than the allowable depreciation.

The following examples demonstrate two specific taxpayers who may benefit from this new automatic consent procedure:

- John Randall acquired a residential rental property in 1992, but mistakenly depreciated it using a 31½-year useful-life schedule instead of the 27½ years allowed for residential rental properties. In 1997, Randall files Form 3115 requesting an automatic change to the new useful life. He will not only be able to deduct the correct depreciation allowable for 1997, but will be able to deduct the differences in depreciation for the years 1992 through 1996.

- Sally Smith acquired a commercial rental property in 1991, but because she had no taxable income, she did not account for depreciation on her tax returns for the years 1991 through 1996. Smith files a Form 3115 in 1997 and is able to deduct depreciation not taken in years 1991 through 1996 on her 1997 tax return. Generally, Smith will also be able to carry undeducted losses forward to future taxable years.

Property managers should note that Revenue Procedure 96-31 does not apply to all properties or all situations. Some exceptions are:

- The automatic consent procedure does not apply to a change from one permissible method of accounting for depreciation to another permissible method. For example, changing from the straight-line method to an acceler-
ated method for the depreciation of furniture and fixtures would not fall within the scope of this revenue procedure. Another example of a change in permissible methods unaffected by the procedure would be a change from charging depreciation reserves with costs of removal and crediting reserves with salvage proceeds, deducting the costs of removal as an expense and then including salvage proceeds in taxable income.

- A change from currently deducting the cost or other basis of any property as an expense to capitalizing and depreciating the cost or other basis does not qualify for this automatic procedure.

- The new procedure does not apply to any property for which a taxpayer has claimed more than the depreciation allowable in prior years. Likewise, it does not apply to any taxpayer if a criminal investigation or proceeding is pending concerning the taxpayer’s federal tax liability for any year or the possibility of fraudulent statements made by the taxpayer.

- Perhaps even more importantly, the new revenue procedure does not apply to any property that continues to be owned by the same taxpayer during a change and in its use. For example, if a taxpayer converts his or her building, which is currently leased to residential tenants and depreciated on a 27 1/2-year life, into a commercial rental property with an allowable life of 39 years, the new revenue procedure would not allow for additional depreciation deductions for the years before the property was converted to commercial use.

How to Effect the Change
The revenue procedure change may be made by completing and filing a current Form 3115 (revised February 1996) in duplicate with the office of Associate Chief Counsel on or before 180 days after the beginning of the year of change, addressed to the Commissioner of Internal Revenue, Attn: CCG:DOM: P&SI:6, Room 5112, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. The taxpayer should type “AUTOMATIC METHOD CHANGE UNDER REV. PROC. 96-31” on the top of the form. Because the Commissioner’s consent is automatic, no user fee is required, and the form will not be acknowledged. A copy of Form 3115 must also be attached to the taxpayer’s timely filed return for the year of the change.

If the taxable year is a short year, taxpayers must file Form 3115 within 180 days of the beginning of the short taxable year, but no later than the last day of the short year (if it is less than 180 days).

IRS Review
Each timely filed Form 3115 is subject to review by the IRS’s national office, and all facts underlying the accounting method change are subject to verification by the appropriate IRS district director. If the IRS determines that the taxpayer’s proposed depreciation method is an impermissible one or that the taxpayer or the property is outside the scope of the automatic consent procedure, the IRS will notify the taxpayer in writing that the automatic consent is not granted. If appropriate, qualifying taxpayers may file a new Form 3115 under the applicable revenue procedure within the prescribed period.

Summary
Revenue Procedure 96-31 allows taxpayers who have claimed less than the allowable depreciation in prior years to make an automatic and “user-fee free” change in their method of accounting for depreciation. Because of certain restrictions that apply and uncertainties that involve new tax laws and revenue procedures, property owners who think they may be eligible to benefit under this new procedure should consult their tax professionals for further guidance. Although the scope of the new procedure is limited, property managers should alert owners to this new set of rules. It could produce a depreciation windfall of tax savings.

Francine J. Lipman is an attorney with Irell & Manella in Newport Beach, Calif. She holds an LLM in taxation and is a CPA.

James E. Williamson, PhD, CPA, is a professor of accounting and taxation at San Diego State University. The authors have collaborated on articles for Tax Notes, Trust & Estates, Real Estate Law Journal, Journal of Real Estate Taxation, and Los Angeles Lawyer.