

Correcting Erroneous Depreciation

Abstract:

Mistakes are common in depreciation calculations. Prior errors can be corrected on a current return if certain rules are followed. The correction procedures and examples are shown in this excerpt.

VI. CORRECTING ERRONEOUS DEPRECIATION

Depreciation is an area of the tax return where mistakes are common. Claiming an incorrect amount of depreciation can result from several mistakes:

1. Posting errors
2. Mathematical errors
3. Using the wrong recovery period or depreciation method
4. Deducting as an ordinary business expense an expenditure that should have been capitalized and depreciated.

MATHEMATICAL AND POSTING ERRORS

The 1999 Publication 946, *How to Depreciate Property* (p. 10), states that if the taxpayer did not deduct the correct amount of depreciation, he or she can file an amended return to make any of the following three corrections:

1. To correct a mathematical error made in any year
2. To correct a posting error made in any year
3. To correct the amount of depreciation for property for which the taxpayer has not adopted a method of accounting

If the taxpayer used an incorrect method of depreciation for the property on two or more consecutively filed tax returns, he or she has adopted a method of accounting for that property. If the taxpayer has adopted a method of accounting, he or she cannot change the method by filing amended returns. If an amended return is allowed, the taxpayer must file it by the later of

1. Three years from the date of filing the original return for the year in which the taxpayer did not deduct the correct amount, or
2. Two years from the time the taxpayer paid the tax for that year

Observation. Correction of mathematical or posting errors is not considered to be a change in accounting method [Treas. Reg. §1.446-1(e)(2)(ii)(b)]. Therefore, such corrections are made on an amended return.

Example 11. Dudley Dunce became aware, when preparing his depreciation schedule for 2000, that he had omitted \$15,000 of depreciation from his 1999 Form 4562 (and Schedule F) due to a posting error.

Question 11A. How should Dudley handle the correction of the error?

Answer 11A. Since this mistake would be classified as a mathematical or posting error, Dudley can file an amended return (Form 1040X) to claim the correct amount of depreciation. Therefore, Dudley would increase his depreciation deduction for 1999 by \$15,000 on the amended return.

Using the Wrong Recovery Period or Depreciation Method. Using a wrong recovery period or a wrong depreciation method is not an unusual occurrence on a tax return. For example, taxpayers may mistakenly use a 7-year life for a 5-year asset, or vice versa. Taxpayers may also be unaware of the requirement to use the 150% declining balance method for farm property rather than the 200% declining balance method. Other farm taxpayers may be subject to the rules of I.R.C. §263A and may have elected to expense preproductive costs. If so, these taxpayers are required to use straight-line depreciation over the alternative depreciable life [Treas. Reg. §1.263A-4T(d)(4)(ii)]. All of these special rules increase the probability of mistakes on the depreciation schedule.

If the taxpayer has used an incorrect depreciation method, the procedure may involve filing an amended return or, alternatively, requesting permission to change the depreciation method. Rev. Proc. 99-49 (I.R.B. 1999-52, Dec. 27, 1999) and Rev. Proc. 98-60 (I.R.B. 1998 51, Dec. 10, 1998) treat a change in depreciation method as a change in method of accounting and set out the procedure for getting permission to change a method of accounting. In general, the rules create an incentive for taxpayers to correct errors in their method of accounting before being subject to examination by the IRS. The incentives are created by giving the taxpayer more favorable terms of making the adjustments to the correct method of accounting.

Example 12. Daisy Flowers paid \$118,500 for a combine for use in her farm business in 1998. She properly claimed an \$18,500 expense deduction under §179 but erroneously used the 200% declining balance method to depreciate the remaining \$100,000 basis. She used the 200% declining balance to depreciate the combine again in 1999.

In 1999, Daisy paid \$69,000 for a tractor for use in her farm business. She again properly claimed a \$19,000 expense deduction under §179 but erroneously claimed 200% declining balance depreciation on the remaining \$50,000 basis.

The depreciation Daisy claimed and the proper depreciation for 1998 and 1999 are as follows:

Asset and Year	§179 Deduction	Depreciable Basis	Depreciation Claimed	Proper Depreciation	Difference
Combine					
1998	\$18,500	\$100,000	\$14,290	\$10,710	\$3,580
1999	0	100,000	24,490	19,130	5,360
Tractor					
1999	19,000	50,000	7,145	5,355	1,790

Daisy purchased another \$76,000 of machinery in 2000 and wants to know how she should report depreciation in 2000.

The depreciation Daisy can claim in 2000 differs according to the year the property was placed in service.

- **Property placed in service in 2000—machinery (\$76,000).** Property placed in service in 2000 must be depreciated using the 150% declining balance method. The improper method claimed on property placed in service in prior years does not require and does not allow Daisy to use the improper method for property placed in service in 2000.

Therefore, she can claim \$20,000 as an expense deduction under §179. On the remaining \$56,000 of basis, she can claim $\$56,000 \times 10.71\% = \$5,998$ of depreciation.

- **Property placed in service in 1999—tractor (\$69,000).** The improper depreciation claimed on property placed in service in 1999 can be corrected by filing an amended return for 1999. Therefore, Daisy can file an amended return for 1999 showing \$5,355 instead of \$7,145 of depreciation. That increases her 1999 income by \$1,790.
- **Property placed in service in 1998—combine (\$118,500).** Daisy has established a method of accounting with respect to the depreciation claimed on the combine placed in service in 1998 since she has used that improper method for two or more years. See Appendix §2.01(2) of Rev. Proc. 99-49, I.R.B. 1999-52 (Dec. 27, 1999). Therefore, she is not allowed to correct the error by filing amended returns for 1998 and 1999. Instead, she must seek the permission of the Commissioner to change her method of accounting and follow the Commissioner's requirements for reporting the adjustment to income that results from changing the method of accounting.

Practitioner Note. Establishing a Method of Accounting. If the proper method of depreciation is used, only one year is needed to establish a method of accounting.

Practitioner Note. When to File Form 3115. Revenue Procedure 99-49 requires the taxpayer to file Form 3115 in duplicate. 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 of Form 3115 must be filed with the IRS national office no earlier than the first day of the year of change and no later than when the original Form 3115 is filed with the tax return for the year of change.

Relief for Late Application. An automatic extension of 6 months from the due date of the return for the year of change (including extensions) is granted to file Form 3115, provided the taxpayer

- a. timely filed (including extensions) its federal income tax return for the year of change,
- b. files an amended return within the 6-month extension period in a manner consistent with the new method,
- c. attaches the original Form 3115 to the amended return,
- d. files a copy of Form 3115 with the IRS national office no later than the filing of the amended return, and
- e. writes at the top of the application "Filed Pursuant to §301.9100-2."

§ 481(a) Adjustment Period. The general rule for a taxpayer-initiated change of accounting method is for the taxpayer to take into account both positive and negative §481(a) adjustments over 4 taxable years. However, a taxpayer may elect to use a 1-year adjustment period in lieu of the 4-year adjustment period if the entire adjustment is less than \$25,000 (either positive or negative). A taxpayer makes an election under the de minimis rule by so indicating on the application.

The adjustment Daisy will make as a result of correcting the depreciation rate on her combine is $\$3,580 + \$5,360 = \$8,940$. Since the total adjustment is less than \$25,000, she can elect to make the entire adjustment in the year of the change instead of the normal 4-year adjustment period. See §5.04(3) of Rev. Proc. 99-49. Daisy makes that election by checking the "yes" box on line 21a of Form 3115 as shown on the following form.

No User Fee Required. A user fee is not required for a change in accounting method filed under Revenue Procedure 99-49 [§6.02(6)]. The receipt of an application filed under this revenue procedure will not be acknowledged by the IRS.

Example 13. Barley Fields purchased a herd of beef cows in 1998 for \$118,500. He properly claimed \$18,500 of §179 expense deduction and used the 150% declining balance rate, but he erroneously used the 10-year recovery period to claim depreciation in 1998 and 1999.

In 1999, he paid \$69,000 for a herd of sheep and claimed a \$19,000 §179 deduction. He claimed the 150% declining balance rate on the remaining \$50,000, but he again erroneously used the 10-year recovery period.

The depreciation Barley claimed and the proper depreciation for 1998 and 1999 are as follows:

Asset and Year	§179 Deduction	Depreciable Basis	Depreciation Proper	
			Claimed	Difference
Beef Cows				
1998	\$18,500	\$100,000	\$ 7,500	\$15,000
(\$7,500)				
1999	0	100,000	13,880	25,500
(11,620)				
Sheep				
1999	19,000	50,000	3,750	7,500
(3,750)				

Barley purchased another \$76,000 of beef cows in 2000 and wants to know how he should report depreciation in 2000.

The depreciation Barley can claim in 2000 differs according to the year the property was placed in service.

- **Property placed in service in 2000—beef cows (\$76,000).** Property placed in service in 2000 must be depreciated using the 150% declining balance method. The improper recovery period claimed on property placed in service in prior years does not require and does not allow Barley to use the improper method for property placed in 2000.

Therefore, he can claim \$20,000 as an expense deduction under §179. On the remaining \$56,000 of basis, he can claim $\$56,000 \times 15.00\% = \$8,400$ of depreciation.

- **Property placed in service in 1999—sheep (\$69,000).** The improper depreciation claimed on property placed in service in 1999 can be corrected by filing an amended return for 1999. Therefore, Barley can file an amended return for 1999 showing \$7,500 instead of \$3,750 of depreciation. That decreases his 1999 income by \$3,750.

- **Property placed in service in 1998—beef cows \$118,500.** Like Daisy in the previous example, Barley has established a method of accounting with respect to the depreciation claimed on the beef cows placed in service in 1998 since he has used that improper method for two or more years. See Appendix §2.01(2) of Rev. Proc. 99-49, I.R.B. 1998-52 (Dec. 27, 1999). Therefore, he is not allowed to correct the error by filing amended returns for 1998 and 1999. Instead he must change his method of accounting.

Unlike Daisy in the previous example, Barley has claimed less than the allowable depreciation. The automatic consent procedure is permitted for property for which either too much or too little depreciation has been claimed. Thus, Barley follows the same procedure as Daisy.

Practitioner Note. Conflict Between Rev. Proc. 98-60 and Form 3115 Instructions.

Revenue Procedures 99-49 and 98-60 state in §4 and in Appendix §2 that the automatic consent procedures apply to a change from an impermissible method of accounting for depreciation to a permissible method of accounting for depreciation, as long as the taxpayer has used the impermissible method in at least two taxable years. The revenue procedure applies whether the taxpayer has claimed less than, **or more than**, the depreciation allowable. The instructions for Form 3115 (May 1999), however, state that the automatic change procedure of Rev. Proc. 98-60 applies only if the taxpayer has used an impermissible method of accounting for depreciation and **has claimed less depreciation than allowable**. Thus, these two authorities appear to conflict. Since the revenue procedure is stronger authority than the form instructions, the practitioner should rely on the revenue procedure until clarification is issued by the IRS. The instructions to Form 3115 state that the taxpayer should determine if the IRS has published guidance after May 1999 on the accounting method being changed.

Deduction of Expenditure Subject to Capitalization. The taxpayer may erroneously treat as an ordinary and necessary business expense an expenditure that is subject to capitalization. This is not a mathematical or posting error. Therefore, it would appear that if the item in question was improperly expensed two or more years ago, the taxpayer has adopted an incorrect method of accounting and must file Form 3115 to rectify the mistake. If only one incorrect tax return has been filed, the taxpayer can file an amended return to correct the mistake.

Example 14. Rose Budd purchased a computer in 1999 for \$2,450. She incorrectly deducted the purchase price as “office expense” on Schedule C. In December 2000, Rose engages an accountant to review her 1999 tax return and to prepare her 2000 return. The accountant questions the large amount of “Office Expense” on the 1999 return. Rose informs the accountant that the amount is the purchase price of a computer.

Question 14A. How should the mistake be rectified?

Answer 14A. Rose should file an amended return for 1999, eliminate the “office expense” of \$2,450, and depreciate the computer over the required 5-year recovery period (using the 200% declining balance method for nonfarm property). Therefore, Rose will reduce “office expense” by \$2,450, and increase depreciation by \$490 (\$2,450 \square 20%) when completing the Form 1040X).

Question 14B. Can Rose elect to expense (under §179) the \$2,450 cost of the computer and thereby avoid any increase in her tax liability on the amended return?

Answer 14B. No, §179 must be elected on the taxpayer’s **first** income tax return for the taxable year to which the election applies (whether or not the return is timely) or on an amended return filed by the due date (including extensions) of the return for that year [Treas. Reg. §1.179-5(a)]. The election is normally made by completing Part I of Form 4562, in which the specific items to be deducted under §179 must be listed. Since Rose did not make an election within the time prescribed, she is not eligible to make the election on an amended return filed after the required date. (See *Robert C. Fors*, T.C. Memo 1998-158.)

IRS Initiated Change. The IRS has issued Notice 98-31 (1998-22 I.R.B. 10), in which it proposed to issue a revenue procedure to cover accounting method changes it initiates. The proposed procedure’s terms and conditions are less favorable than those available for changes initiated under the voluntary request procedures of Rev. Proc. 99-49 and Rev. Proc. 98-60. This encourages taxpayers to voluntarily request to change from incorrect accounting methods before being contacted for examination.

An examining agent changing a taxpayer’s method of accounting is required to impose the I.R.C. §481(a) adjustment in the earliest tax year under examination (or, if later, the first tax year the method is considered impermissible). **The adjustment will normally be imposed in a one-year adjustment period.** An appeals officer or government counsel may, however, agree to terms more favorable to the taxpayer, but the result will likely be less favorable than a taxpayer-initiated change.

The proposed procedure would be effective for the examiner’s report issued, and for Forms 870 AD and closing agreements executed 90 or more days after the revenue procedure is published in the IRB. Taxpayers and the IRS, however, could agree to apply the procedure to closing agreements executed on or after August 30, 1998.