EFFECTIVE CHANGE IN THE “ALLOWED OR ALLOWABLE” RULE

All professional tax preparers are familiar with the requirement that when determining the adjusted basis of property being sold, the prior depreciation allowed *or allowable* must be subtracted from the original cost. What a surprise this can be for the unwary taxpayer. For example:

One of my long-time farm/ranch clients recently retired and sold the entire ranch operation, including cattle, sheep, machinery and equipment, buildings and land. The sale was contingent on an acceptable appraisal. After the closing date, the rancher asked me to calculate his gain as he was worried about the depreciation recapture. I told him this should not be difficult as I simply had to match each item on the appraisal to the identical item on the depreciation schedule to determine the character of gain. The problem was the appraisal listed three barns, but I was missing one barn on the depreciation schedule appraised at $100,000. In the ensuing telephone call with the rancher, I discovered that he never informed me about the third barn, which he had built 20 years previously for $100,000. Because I had to subtracted the depreciation “allowed or allowable” from his cost, this resulted in a $100,000 gain with no previous tax benefit. Ouch! I immediately called him, asking if he had deducted the $100,000 as some other item in the year the barn was built (e.g., as seed or fertilizer) and he said no. I believed him. When I asked him why he had never informed me of the barn construction, he replied “because we have never needed the deduction until now!” So you also have my client?

Let’s review the application of the allowed or allowable rule to changes in method of accounting. §1016(a)(2) provides that the basis of property is adjusted in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount allowed as deductions in computing taxable income and resulting in a reduction for any taxable year of the taxpayer's taxes, ***but not less than the amount allowable.***

Two year ago, the IRS issued Rev. Proc. 2002-9 to permit a taxpayer who had claimed less than the depreciation allowable for its property to change its method of determining depreciation for the property. This guidance has enabled many taxpayers who had claimed less than the depreciation allowable to claim the full depreciation allowable. The one problem with Rev. Proc. 2002-9 was when the discovery of the unclaimed depreciation was made ***after*** disposition, the taxpayer was not allowed to deduct the unclaimed depreciation but was still required to subtract it from the original purchase price to arrive at the adjusted basis.

The IRS recently issued Rev. Proc. 2004-11 which permits a taxpayer to make this change even ***after*** the disposition of the depreciable property. Revenue Procedure 2004-11 allows a taxpayer to change the taxpayer's method of determining depreciation for a depreciable or amortizable asset after its disposition if the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable, for the asset in computing taxable income in the year of disposition or in prior taxable years. Because the taxpayer is permitted to claim the allowable depreciation not taken into account for this asset, the taxpayer's lifetime income is not permanently affected by the "allowed or allowable" rule under

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§1016(a)(2).

In other words, new Rev. Proc. 2004-11 allows the taxpayer to deduct the unclaimed depreciation even after disposition. With this, the IRS effectively did away with the “allowable” depreciation rule! As a result, a taxpayer who has claimed less than the depreciation allowable for its property will no longer risk permanently losing an allowable depreciation deduction. Sometimes even the IRS gets one right! Simply claim the underreported “allowable” depreciation on the same tax return reporting the sale.

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