Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:LN:POSTF-123493-02
EYWu

date: JUN 7 2002

to: [redacted], Case Manager
[redacted], Revenue Agent HMCT [redacted]

from: June Y. Bass, Associate Area Counsel (LMSB)
Joyce M. Marr, Senior Attorney (LMSB)
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subject: Taxpayer: [redacted], Inc.
Tax Years: [redacted] through [redacted]
Issue: I.R.C. §§ 167, 168

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum responds to your request for our advice concerning the depreciation of certain tooling. This memorandum should not be cited as precedent.

ISSUE

What is the class life of the tooling that is owned by a [redacted] distributor but leased to [redacted] manufacturers who use it to make parts for [redacted]?

CONCLUSION

The tooling has a 3-year class life because it falls within asset class [redacted] of Rev. Proc. [redacted].

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FACTS[1]

[redacted], Inc. (the "Taxpayer") was a wholly-owned subsidiary of [redacted] ("[redacted]"), a [redacted] corporation. [redacted] was [redacted]% owned by [redacted] ("[redacted]").

The Taxpayer was in the business of distributing [redacted]. The Taxpayer purchased the [redacted] from the manufacturers, sold them to the regional distributors, who then allocated the [redacted] to independent [redacted] [redacted] for retail sale to the public. All the [redacted] distributed by the Taxpayer were domestically manufactured by [redacted] and [redacted] [redacted] Inc. ("[redacted]"). [redacted] was a joint venture formed by [redacted] and [redacted]. The Taxpayer did not conduct any manufacturing activity.

On Schedule K of the Forms 1120 filed for the years at issue, the Taxpayer identified itself as in the business of wholesale trade.

Between [redacted] and [redacted], the Taxpayer purchased a number of tooling machines from [redacted] and [redacted] (collectively the "Manufacturers"). The Manufacturers, in turn, leased the tooling from the Taxpayer to make parts for their [redacted]. The Manufacturers compensated the Taxpayer by reducing the price on the [redacted] that they sold to the Taxpayer. Attached hereto as Exhibit A are two lease agreements representative of the Taxpayer's arrangements with the Manufacturers on the tooling. Exam does not question the validity of these leases.

The Taxpayer depreciated the tooling over three years using the double declining balance method of the general depreciation system under I.R.C. § 168(a). The Taxpayer believes the tooling falls within asset class [redacted] of Rev. Proc. [redacted], which has a class life and a recovery period of 3 years. Citing Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b), the Taxpayer argues that a property's class life should be determined based on its primary use and not the taxpayer's business activity. See the Taxpayer's position paper dated [redacted], [redacted], and attached hereto as Exhibit B.

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[1] Our understanding of the facts of this case is limited to the facts presented by you. We have not undertaken any independent investigation of the facts of this case. If the actual facts are different from the facts known to us, our legal analysis and our conclusions and recommendations might be different. Accordingly, if you learn that the facts known to us are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

DISCUSSION

I. Applicable Law.

I.R.C. § 167 allows a taxpayer to take a depreciation deduction for the exhaustion, wear and tear of property used in its trade or business, or of property held for the production of income.

For tangible property placed in service after 1986, such as the tooling in this case, the § 167 depreciation deduction is generally determined under I.R.C. § 168. Section 168 prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in § 168(a); and (2) the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention. Except for situations not pertinent here,[2] the recovery period is tied to the class life of the property. For instance, property with a class life of 4 years or less is classified as a 3-year property subject to a 3-year recovery period, and property with a class life of more than 4 years but less than 10 years is classified as a 5-year property subject to a 5-year recovery period. See I.R.C. §§ 168(c) and 168(e)(1).

The term "class life" is defined by I.R.C. § 168(i)(1) as the class life that would be applicable to any property as of January 1, 1986, under former I.R.C. § 167(m) as if it were in effect, and the taxpayer were an elector. Prior to its revocation, § 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary. Section 167(m) also authorized the Commissioner to promulgate regulations to provide further guidance on class lives of depreciable assets. Accordingly, the Commissioner issued Treas. Reg. §§ 1.167(a)-11(b)(4)(iii)(b), and 1.167(a)-11(e)(3)(iii), and [redacted].

Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b) sets forth the method for asset classification under former § 167(m). That regulation provides that property is to be included in the asset guideline class for the activity in which the property is primarily used, even though that use may be insubstantial in relation to all the taxpayer's other activities. As for leased property, Treas. Reg. § 1.167(a)-11(e)(3)(iii) carves out a special rule to treat the lessee as the owner of the property in determining the appropriate asset class for depreciation by the lessor. This special rule applies unless (1) there is an asset guideline class in effect for the lessor, and (2) the classification is based on the type of property (such as trucks or railroad

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[2] Certain property is classified by statute regardless of its class life. For example, any qualified technological equipment as defined in I.R.C. § 168(i)(2) is classified as 5-year property. I.R.C. § 168(e)(3)(B)(iv). Also, any property that does not have a class life and is not otherwise classified under § 168(e)(2) or (3) is classified as 7-year property. I.R.C. § 168(e)(3)(C)(ii).

cars) as opposed to the activity in which the property is used. See Treas. Reg. § 1.167(a)-11(e)(3)(iii).

Rev. Proc. [redacted] sets forth the current class lives and recovery periods of property subject to § 168. It divides depreciable assets into two broad categories: (1) asset classes 00.11 through 00.4, consisting of specific assets used in all business activities (the "Asset Category"); and (2) asset classes 01.1 through 80.0, consisting of assets used in specific business activities (the "Activity category"). A property should be classified in the Activity Category, unless that property can be classified in the Asset Category. See Norwest Corporation & Subsidiaries v. Commissioner, 111 T.C. 105 (1998).

II. Analysis.

This case involves a leased property. We therefore must determine whether Treas. Reg. § 1.167(a)-11(e)(3)(iii) applies. If it does, the tooling will be treated as owned by the Manufacturers and its class life will be determined based on the Manufacturers' activities instead of the Taxpayer's activity.

Here, the tooling does not fit into the Asset Category. Nor is there an asset class in the Activity Category that describes the Taxpayer's leasing activity with respect to the tooling. Consequently, Treas. Reg. § 1.167(a)-11(e)(3)(iii) will treat the tooling as owned by the Manufacturers and will place the tooling within the asset class that best describes the Manufacturers' activities. In this regard, we believe asset class [redacted], of Rev. Proc. [redacted] is the class to which the tooling belongs. Asset class [redacted] includes assets defined as special tools, such as jigs, dies, fixtures, molds, patterns, gauges, and specialty transfer and shipping devices owned and used by manufacturers of finished [redacted] in qualified activities such as part manufacturing. Assets included in this class have a class life and a recovery period of 3 years for purposes of § 168(a).

III. Taxpayer's Argument

While we reached the same conclusion as the taxpayer's, we disagree with the taxpayer's rationale.

Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b), the section that the Taxpayer relies on, does not stand for the proposition that assets should be classified based on their usage rather than the taxpayer's business activity. To the contrary, the language of that section requires us to look to the taxpayer's activity in which the depreciable property is used regardless of how insignificant that activity is compared to the taxpayer's other activities. The taxpayer's interpretation of Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b) ignores the fundamental tax principle that a depreciation deduction depends on the use of the depreciable property in the trade or business of the taxpayer having a depreciable interest in the property.

Under the class life depreciation regime, a taxpayer seeking to classify a property under a business activity asset class must itself be engaged in the activity described by that asset class. But for the special rule of Treas. Reg. § 1.167(a)-11(e)(3)(iii), the tooling would not have qualified for asset class [redacted] because the Taxpayer was not a manufacturer of finished [redacted] components.

This advice has been informally coordinated with the Passthroughs and Special Industries Branch of the National Office and will be forwarded to that Branch for post-review. Please contact Erica Wu at (949)360-2678 if you have any questions.