Department of the Treasury | **Internal Revenue Service** | **Office of Chief Counsel**

Notice

[CC-2004-007]

January 28, 2004

Subject: Change in Litigating Position – Application of Section 446(e) to Changes in Computing Depreciation

Cancel Date: Upon Incorporation into CCDM

Purpose

This notice announces a change in the Service=s litigating position concerning whether a change in computing depreciation under section 167, 168 (MACRS), 197, 1400I, 1400L(b), or 1400L(c), or former section 168 (ACRS) is a change in method of accounting under section 446(e).

Background

Currently, the Service=s litigating position is that a change in computing depreciation under section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or ACRS generally is a change in method of accounting under section 446(e) for which the consent of the Commissioner of Internal Revenue is required. However, this position has been successfully challenged by several taxpayers in recent litigation with respect to depreciable property subject to section 168 (MACRS property).

Section 446(e) provides that, except as otherwise provided in this chapter, a taxpayer who changes the method of accounting on the basis of which the taxpayer regularly computes the taxpayer's income in keeping the taxpayer's books shall, before computing the taxpayer's taxable income under the new method, secure the consent of the Secretary.

Treas. Reg. ' 1.446-1(e)(2)(ii)(a) (in effect prior to the issuance of TD 9105, 69 FR 5, January 2, 2004) provides in pertinent part that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. However, Treas. Reg. ' 1.446-1(e)(2)(ii)(b) (in effect prior to the issuance of TD 9105, 69 FR 5, January 2, 2004) provides in pertinent part that a change in method of accounting does not include an adjustment in the useful life of a depreciable asset.

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Although such adjustment may involve the question of the proper time for the taking of a deduction, such item is traditionally corrected by adjustments in the current and future years.

On May 13, 1996, the Service issued Rev. Proc. 96-31, 1996-1 C.B. 714, providing that a change from not claiming the depreciation or amortization allowable to claiming the depreciation or amortization allowable is a change in method of accounting for which the consent of the Commissioner of Internal Revenue is required.

In Kurzet v. Commissioner, 222 F.3d 830, 842-845 (10th Cir. 2000), the taxpayer sought to change the classification of MACRS property from nonresidential real property to 15-year property thereby resulting in a change in recovery period from 31.5 years to 15 years. The Tenth Circuit held that a change in recovery period under MACRS is a change in method of accounting under section 446(e). In reaching its holding, the Tenth Circuit considered Rev. Proc. 96-31 and concluded that the Commissioner=s position in Rev. Proc. 96-31 interpreting the regulations under section 446(e) as requiring a taxpayer to obtain permission for a change in recovery period is not Aplainly erroneous@ or Ainconsistent@ with those regulations.

Recently, two other circuits have held otherwise. In Brookshire Brothers Holding, Inc. & Subsidiaries v. Commissioner, 320 F.3d 507 (5th Cir. 2003), aff=g. T.C. Memo. 2001-150, reh'g en banc denied, 65 Fed. Appx. 511 (5th Cir. 2003), the Fifth Circuit held that a change in classification under MACRS is the functional equivalent of a change in useful life and, therefore, such a change falls under the useful life exception in Treas. Reg. ' 1.446-1(e)(2)(ii)(b). However, the court did not address Rev. Proc. 96-31 in reaching the holding. The Eighth Circuit in O=Shaughnessy v. Commissioner, 332 F.3d 1125 (8th Cir. 2003), rev=g in part 2002-1 U.S.T.C. (CCH) &50,235 (D. Minn. 2001), adopted the analysis in Brookshire and held that a change in classification under MACRS falls within the useful life exception and, thus, does not constitute a change in method of accounting.

The Tax Court extended its reasoning in Brookshire in Green Forest Manufacturing Inc. v. Commissioner, T.C. Memo. 2003-75. Citing its own opinion in Brookshire, the court held that a change in computing depreciation from the general depreciation system in section 168(a) to the alternative depreciation system in section 168(g) is a change in classification that falls within the useful life exception and, accordingly, is not a change in method of accounting.

On December 30, 2003, the Service and Treasury issued Treas. Reg. § 1.446-1T(e)(2)(ii)(d) (TD 9105, 69 FR 5, January 2, 2004) providing the changes in computing depreciation or amortization under section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or ACRS that are, and are not, a change in method of accounting under section 446(e). With respect to a change in depreciation or amortization that is a change in method of accounting, these regulations apply to such a change in method of accounting made for

taxable years ending on or after December 30, 2003. With respect to a change in depreciation or amortization that is not a change in method of accounting, the regulations apply to such a change made for taxable years ending on or after December 30, 2003.

Also, on December 30, 2003, the Service released an advance copy of Rev. Proc. 2004-11, 2004-3 I.R.B. 311, that, in part, modified Rev. Proc. 2002-9, 2002-1 C.B. 327 (the automatic consent change in method of accounting revenue procedure) by deleting sections 2.01, 2.02, and 2B of the Appendix of Rev. Proc. 2002-9 and replacing those sections with new sections 2.01, 2.02, and 2B of the Appendix. New section 2.01 of the Appendix generally applies to certain changes from an impermissible to a permissible method of accounting for depreciation or amortization. New section 2.02 of the Appendix applies to certain changes from a permissible to another permissible method of accounting for depreciation. New section 2B of the Appendix applies to computer software expenditures. These new sections 2.01, 2.02, and 2B of the Appendix of Rev. Proc. 2002-9 generally apply to a Form 3115, Application for a Change in Method of Accounting, filed for taxable years ending on or after December 30, 2003.

Change in Litigating Position

The Service=s position continues to be that a change in computing depreciation under section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or ACRS generally is a change in method of accounting under section 446(e) for which the consent of the Commissioner of Internal Revenue is required. However, for depreciable or amortizable property placed in service by the taxpayer in taxable years ending before the effective date of Treas. Reg. § 1.446-1T(e)(2)(ii)(d), the Service will not assert that a change in computing depreciation under section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or ACRS for depreciable or amortizable property that is treated as a capital asset under the taxpayer's present and proposed methods of accounting is a change in method of accounting under section 446(e). Consequently, if, for example, a taxpayer completes a cost segregation study in 2004 for its MACRS property placed in service in 2001 and, as a result, reclassifies that property from nonresidential real property to 15-year property under section 168(e), the Service will not assert that the change in computing depreciation resulting from this reclassification is a change in method of accounting under section 446(e) and, accordingly, the taxpayer may file amended federal tax returns for 2001 and any affected subsequent taxable year to effect this change in computing depreciation. Alternatively, the taxpayer may treat this change in computing depreciation as a change in method of accounting and, thus, file a Form 3115 under new section 2.01 of the Appendix of Rev. Proc. 2002-9 for the current taxable year (provided the filing requirements of Rev. Proc. 2002-9 are met, and the taxpayer and the property are within the scope of Rev. Proc. 2002-9 and new section 2.01 of the Appendix of Rev. Proc. 2002-9).

Similarly, if, for example, the same cost segregation study determined that some of the taxpayer's MACRS property that is reported as being placed-in-service by the taxpayer in 2002 was actually placed-in-service by the taxpayer in 2001, the Service will not

litigate whether or not the change in computing depreciation resulting from this change in placed-in-service date is a change in method of accounting under section 446(e) and, accordingly, the taxpayer may file amended federal tax returns for 2001 and any affected subsequent taxable year to effect this change in computing depreciation. Alternatively, the taxpayer may treat this change in computing depreciation as a change in method of accounting and, thus, file a Form 3115 under Rev. Proc. 97-27, 1997-1 C.B. 680, for the current taxable year (provided the filing and scope limitations of Rev. Proc. 97-27 are met). New sections 2.01, 2.02, and 2B of the Appendix of Rev. Proc. 2002-9 do not apply to a Form 3115 filed for taxable years ending on or after December 30, 2003, for a change in computing depreciation resulting from a change in placed-in-service date.

This change in the Service's litigating position does not apply to an adjustment in useful life under section 167 (other than under MACRS, section 1400I, section 1400L, or ACRS) if the useful life is not specifically assigned by the Internal Revenue Code, the regulations thereunder, or other guidance published in the Internal Revenue Bulletin, to any adjustment to correct an incorrect classification or characterization of depreciable property for which depreciation is determined under Treas. Reg. § 1.167(a)-11 (CLADR property), or to a change in computing depreciation or amortization due to a posting error, a mathematical error, a change in underlying facts (other than a change in the placed-in-service date), a change in use of property in the hands of the same taxpayer, the making of a late election, or a revocation of an election. These changes in depreciation or amortization are not a change in method of accounting. Accordingly, field personnel should consult with their local Chief Counsel attorneys when a taxpayer asserts that such a change is a change in method of accounting.

Similarly, the change in the Service's litigating position does not apply to a change in the treatment of property from a non-capital asset (for example, inventory, materials and supplies) to a capital, depreciable or amortizable asset (or vice versa), or to a change from expensing the cost of depreciable or amortizable property to capitalizing and depreciating or amortizing such cost (or vice versa). These changes are a change in method of accounting under section 446(e). Accordingly, field personnel should consult with their local Chief Counsel attorneys when a taxpayer asserts that these changes are not a change in method of accounting.

If you have any questions regarding this notice, please contact Sara Logan or Douglas Kim, Passthroughs and Special Industries, at (202) 622-3110.

/s/
Heather C. Maloy
Associate Chief Counsel
(Passthroughs and Special Industries)