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INTERNAL REVENUE SERVICE
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MEMORANDUM FOR DISTRICT COUNSEL
DISTRICT

FROM: Senior Technician Reviewer, Branch 6
CC:DOM:P&SI:6

SUBJECT: Application of Section 168(j) of the Internal Revenue Code to Certain Mobile Assets

This written technical assistance responds to your inquiry dated May 28, 1999. This technical assistance is advisory only, is not binding on District Counsel, Examination or Appeals, is not to be furnished or cited to taxpayers or their representatives, and is not to serve as the basis for closing a case. Also, the substance of this memorandum will not be recommended for publication as a revenue ruling or revenue procedure. This document is not to be cited as precedent.

ISSUES:

1. Whether rolling stock or other mobile assets (hereafter, collectively referred to as "mobile assets") that are used both on and off an Indian reservation satisfy the requirements of section 168(j)(4)(A)(i) and (ii)?

2. If a taxpayer mistakenly used a recovery period in section 168(c) for qualified Indian reservation property on two or more consecutively filed federal tax returns, may the taxpayer file amended returns to change from that recovery period to the applicable recovery period in section 168(j)?

CONCLUSIONS:

1. To meet the requirements of section 168(j)(4)(A)(i) and (ii), mobile assets must (i) be used by the taxpayer more than 50 percent of the time during the taxable year in the active conduct of a trade or business within an Indian reservation, and (ii) not

be used or located outside the Indian reservation on more than an occasional or incidental basis during the taxable year. The determination of whether mobile assets that are used both on and off an Indian reservation satisfy the requirements of section 168(j)(4)(A)(i) and (ii) for the taxable year is made in light of all the facts and circumstances and is made on an asset-by-asset basis.

2. If a taxpayer mistakenly used a recovery period in section 168(c) for qualified Indian reservation property on two or more consecutively filed federal tax returns, a change from that recovery period to the applicable recovery period in section 168(j) is a change in method of accounting that requires the consent of the Commissioner of Internal Revenue. To obtain this consent, the taxpayer must file Form 3115, Application for Change in Accounting Method. Accordingly, the taxpayer may not file amended returns to make this change in recovery period.

FACTS:

On original or amended federal tax returns, taxpayers are treating mobile assets that are used both on and off an Indian reservation as qualified Indian reservation property for purposes of section 168(j). Mobile assets include trucks, cars, airplanes, buses, and mobile heavy equipment, such as oil and gas drilling equipment, cranes, and grain combines. In some cases, these mobile assets may be used outside the Indian reservation from 5 percent to more than 50 percent of the asset's usage during a taxable year. Further, the administrative offices of the taxpayer's business may be located outside the Indian reservation.

LAW AND ANALYSIS:

Issue 1

Section 13321 of the Omnibus Budget Reconciliation Act of 1993, 1993-3 C.B. 3, 146, added new section 168(j) to the Code. Section 168(j)(1) provides that for purposes of section 168(a), the applicable recovery period for qualified Indian reservation property is determined in accordance with the table contained in section 168(j)(2) in lieu of the table contained in section 168(c). The table in section 168(j)(2) provides recovery periods that are shorter than the recovery periods provided under the table in section 168(c). Section 168(j) is effective for property placed in service after December 31, 1993.

Only "qualified Indian reservation property" is eligible to use the recovery periods provided in section 168(j). To be treated as "qualified Indian reservation property"

section 168(j)(4)(A) generally requires the property to be:

(i) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation;

(ii) not used or located outside the Indian reservation on a regular basis;

(iii) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C); and

(iv) not property (or any position thereof) placed in service for purposes of conducting or housing class I, II, or III gaming (as defined in section 4 of the Indian Regulatory Act (25 U.S.C. 2703).

Special rules apply to certain infrastructure property located outside an Indian reservation if the purpose of such property is to connect to infrastructure property located within the Indian reservation. See section 168(j)(4)(C).

The term "Indian reservation" is defined in section 168(j)(6) as meaning a reservation, as defined in either section 3(d) of the Indian Financing Act of 1974, 25 U.S.C. § 1452(d), or section 4(10) of the Indian Child Welfare Act of 1978, 25 U.S.C. § 1903(10). Section 3(d) of the Indian Financing Act of 1974 defines reservation to include "former Indian reservations in Oklahoma." Flush language in section 168(j)(6) specifically provides how section 3(d) of the Indian Financing Act shall be applied in its treatment of the term "former Indian reservations in Oklahoma." See Notice 98-45, 1998-35 I.R.B. 7, for discussion of the definition of "former Indian reservations in Oklahoma" for purposes of section 168(j)(6).

Based on the language on section 168(j)(4), the conditions imposed by section 168(j)(4)(A) are applied each taxable year on an asset-by-asset basis to determine whether each mobile asset in question meets the definition of qualified Indian reservation property under section 168(j)(4). Further, qualified Indian reservation property is subject to the general rules of section 168. For example, if a mobile asset meets the definition of qualified Indian reservation property in Year 1 but does not meet such definition in Year 2 while it continues to be held by the same person, there is a change in use of the mobile asset and section 168(i)(5) applies in determining depreciation of the mobile asset in Year 2.

To meet the requirements for "qualified Indian reservation property," sections 168(j)(4)(A)(i) and (ii) impose two key conditions. First, section 168(j)(4)(A)(i) requires the property to be used predominantly in the active conduct of a trade or business within an Indian reservation. Second, section 168(j)(4)(A)(ii) prohibits using or locating the property outside the Indian reservation on a regular basis.

Accordingly, a close nexus between the Indian reservation and the property is required.

To apply section 168(j)(4)(A)(i), we must define the term“predominantly” and determine what Congress envisioned by requiring that an asset be “used ... predominantly in the active conduct of a trade or business within an Indian reservation.”

Neither section 168(j) nor the legislative history defines the term “predominantly” for purposes of section 168(j). However, the term “predominantly” is used in section 168(g)(1)(A). This section provides that the alternative depreciation system of section 168(g) applies to any tangible property that during the taxable year is used predominantly outside the United States. Rev. Rul. 90-9, 1990-1 C.B. 46, interprets “used predominantly outside the United States” as meaning located outside the United States during more than 50 percent of the taxable year. See also Norfolk Southern Corp. v. Commissioner, 104 T.C. 13, 43 (1995) (interpreted the phrase “used predominantly outside the United States” for purposes of the investment credit and depreciation under former section 168 (ACRS) as meaning physically located outside the United States more than 50 percent of the time during the taxable year). We believe that a different threshold should not be imposed with respect to section 168(j). Accordingly, our view is that the term “predominantly” for purposes of section 168(j) means more than 50 percent of the time during the taxable year.

In applying this more than 50 percent test under section 168(j)(4)(A)(i), it is necessary to determine the appropriate nexus that the standard “used .... predominantly in the active conduct of a trade or business within an Indian reservation” of section 168(j)(4)(A)(i) requires. [1] Because of the existence of section 168(j)(4)(A)(ii), it is unlikely that the standard addresses the percentage of time the property is used or located within an Indian reservation. Instead, our view is that the standard requires a connection between the trade or business operated within an Indian reservation and the use of the property in carrying on that trade or business. For example, a car that is used in the trade or business of providing taxi service only within an Indian reservation and is also used for personal purposes, must be used more than 50 percent of the time during the taxable year in that taxi service to satisfy the requirement of section 168(j)(4)(A)(i). Further, for example, we believe that in those instances where a corporate taxpayer’s headquarters are located off an Indian reservation but the taxpayer operates a manufacturing plant within the Indian reservation, the standard of section 168(j)(4)(A)(i) is satisfied.

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[1] The legislative history states that rental of real property located within an Indian reservation is treated as an active trade or business. H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess., 1, 722, 1993-3 C.B. 393, 600 fn85. See section 168(j)(5) of the Code.

With respect to the condition in section 168(j)(4)(A)(ii), neither the statute nor the legislative history defines the phrase "used or located outside the Indian reservation on a regular basis." However, in interpreting similar language in section 280A(c)(1), the Tax Court in Jackson v. Commissioner, 76 T.C. 696, 700-701 (1981), determined that, to establish business use on a "regular basis," business use must be more than occasional or incidental. We believe this interpretation comports with the ordinary meaning of "regular basis."

The determination of whether a mobile asset is used or located outside the Indian reservation on more than an occasional or incidental basis during the taxable year is made in light of all the facts and circumstances. Because of the factual nature of this determination, we are reluctant to adopt any bright line test (for example, a percentage of usage outside of the Indian reservation). [2]

In summary, to meet the requirements of section 168(j)(4)(A)(i) and (ii), mobile assets must (i) be used by the taxpayer more than 50 percent of the time during the taxable year in the active conduct of a trade or business within an Indian reservation, and (ii) not be used or located outside the Indian reservation on more than an occasional or incidental basis during the taxable year. The determination of whether mobile assets that are used both on and off an Indian reservation satisfy the requirements of section 168(j)(4)(A)(i) and (ii) for the taxable year is made in light of all the facts and circumstances and is made on an asset-by-asset basis.

Issue 2

Section 1.167(e)-1(a) of the Income Tax Regulations provides that any change in the method of computing the depreciation allowances with respect to a particular account is a change in method of accounting and such a change will be permitted only with the consent of the Commissioner. The regulation further provides that any request for a change in method of depreciation shall be made in accordance with section 446 and the regulations thereunder.

Section 446(e) provides that except as otherwise expressly provided in chapter 1 of the Code, a taxpayer who changes the method of accounting on the basis of which the taxpayer regularly computes income in keeping the taxpayer's books shall, before computing taxable income under the new method, secure the consent of the

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[2] For example, we believe that consideration should be given to certain aberrations of usage by a mobile asset (for example, a one-time, large amount of usage outside of the reservation) in determining whether the mobile asset has been used outside of the Indian reservation on a regular basis.

Secretary. Section 1.446-1(e)(2)(i) provides that consent must be secured whether or not such method is proper or is permitted under the Code or the regulations thereunder.

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the treatment of any material item and defines the term "material item" as meaning any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. In determining whether a taxpayer's practice for an item involves timing, section 2.01(1) of Rev. Proc. 97-27, 1997-1 C.B. 680, 681, provides that the relevant question generally is whether the practice permanently changes the amount of taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, the practice involves timing and, thus, is a change in method of accounting.

Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, section 1.446-1(e)(2)(ii)(a) further provides that in most instances a method of accounting is not established for an item without consistent treatment. For purposes of this regulation, the erroneous treatment of a material item in the same way in two or more consecutively filed tax returns represents consistent treatment of that item. See Rev. Rul. 90-38, 1990-1 C.B. 57; section 2.01(2) of Rev. Proc. 97-27, 1997-1 C.B. at 681.

Section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include an adjustment in the useful life of a depreciable asset. The regulation further provides that a change in method of accounting does not include a change in treatment resulting from a change in underlying facts.

A change from a taxpayer's impermissible method of accounting for depreciation under which the taxpayer did not claim the depreciation allowable to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable is a change in method of accounting for which the consent of the Commissioner is required. See sections 1.167(e)-1(a) and 1.446-1(e)(2)(ii). While under section 1.446-1(e)(2)(ii)(b), a change in useful life of property is not a change in method of accounting, a change in the recovery period of property generally is a change in method of accounting. The terms "recovery period" and "useful life" are not synonymous terms. Pursuant to section 1.167(a)-1(b), the estimated useful life of property is the period over which the property may reasonably expected to be useful to a taxpayer in its trade or business or in the production of its income. In contrast, the recovery period of property is a prescribed period that is assigned to each class of property under section 168(e) and, consequently, may or may not reflect the period over which the property may be useful to the taxpayer in its trade or business or in the production of its income. Because a change in recovery period affects the timing of depreciation deductions,

a change in recovery period that does not result from a change in underlying facts (for example, a change in use of the property) is a change in method of accounting.

If a taxpayer mistakenly used a recovery period in section 168(c) for qualified Indian reservation property on two or more consecutively filed federal tax returns, the taxpayer has established a method of accounting for depreciating this property. See section 1.446-1(e)(2)(ii)(a) and Rev. Rul. 90-38. Whether or not this method of accounting is permissible, the taxpayer may not change its method of accounting without first obtaining the Commissioner's consent. In this case, a change from the recovery period in section 168(c) to the applicable recovery period in section 168(j) does not result from any change in underlying facts and, accordingly, this change in recovery period is a change in method of accounting.

To obtain the Commissioner's consent to make this change in method of accounting, section 1.446-1(e)(3)(i) requires the taxpayer to file Form 3115, Application for Change in Accounting Method, with the Commissioner during the taxable year in which the taxpayer desires to make the change in accounting method. See also section 5.01 of Rev. Proc. 97-27, 1997-1 C.B. at 684. However, if the taxpayer and the property are within the scope of Rev. Proc. 98-60, 1998-51 I.R.B. 16, including its APPENDIX, see section 6.02 of this revenue procedure for the requirements for filing the Form 3115.

We hope that the above information is helpful to you. If you have any questions on these matters, please call (202) 622-3110.

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