

APPEALS

INDUSTRY SPECIALIZATION PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: MAQUILADORA

ISSUE: SECTION 168(g)

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SETTLEMENT GUIDELINES

STATEMENT OF ISSUES

Issue 1

What is a U.S. entity's depreciation deduction for tangible property transferred to a maquiladora located in Latin America?

Issue 2

Does a change from the general depreciation system under IRC sections 168(a) (as determined under IRC sections 168(b), 168(c), and 168(d)) to the alternative depreciation system under section 168 (g) (2) by the U.S. entity constitute a change in method of accounting to which provisions of IRC sections 446 and 481 apply?

COMPLIANCE POSITION

Issue 1

The U.S. entity must compute the depreciation deduction under the alternative depreciation system contained in I.R.C. section 168(g)(2) for any tangible property that during the taxable year is used predominantly outside the U.S. and that is not described in section 168(g)(4).

Issue 2

A change from the general depreciation system under IRC section 168 (a) to the alternative depreciation system under section 168 (g) (2) may constitute a change in method of accounting to which the provisions of IRC sections 446 and 481 apply.

If a U.S. entity that was properly depreciating property under the general depreciation system transfers the property from the U.S. to a maquiladora that uses the property predominately outside the U.S., a change in use of the property occurs. If the U.S. entity begins to use the alternative depreciation system of I.R.C. section 168(g)(2) for this property the first year the property is used predominantly outside the U.S., no

change in method of accounting is required because of this change in use.

However, if the U.S. entity continues to use the general depreciation system for the property, the U.S. entity is using an erroneous method of accounting for depreciation of the property. Generally, a change from this erroneous method for depreciation to the alternative depreciation system of I.R.C. section 168(g)(2) for the second year after the first year the property is used predominantly outside the U.S. is a change in method of accounting to which the provisions of I.R.C. sections 446 and 481 apply. However, no change in method of accounting occurs if the U.S. entity uses the general depreciation system for the property for the first year the property is used predominantly outside the U.S. and, before filing the tax return for the next year, the U.S. entity files an amended return for the first year the property is used predominantly outside the U.S. using the alternative depreciation system of I.R.C. section 168(g)(2) for the property. See Rev. Rul. 72-491, 1972-2 C.B. 104.

If there is a change in method of accounting, the net adjustment required under I.R.C. section 481(a) is computed as of the beginning of the year of the change in method of accounting. The positive section 481(a) adjustment (increase in income) is computed for property on hand as of the beginning of the year of the method change and is the difference between:

a) the total amount of accelerated depreciation (as determined under I.R.C. sections 168(b),(c), and (d)) for the depreciable property taken by the U.S. entity for years beginning with the first year the property was used predominantly outside the U.S. and before the year of the change in method of accounting,

and

b) the total amount of depreciation allowable for the depreciable property under the alternative depreciation system (as determined under I.R.C. section 168(g)) to the U.S. entity for years beginning with the first year the property is used predominantly outside the U.S. and before the year of change in method of accounting.

The amount of the positive section 481(a) adjustment, however, must be adjusted for any corresponding change in the depreciation amount that is required to be capitalized by the U.S. entity under any provision of the Code (for example, capitalized to the cost of the U.S. entity's inventory under section 263A).

A change in method of accounting, as described above, that is made by the Director as part of an examination of the taxpayer's return(s) will ordinarily be made in the earliest taxable year under examination or, if later, the first taxable year the property was used predominantly outside the U.S. Further, the entire amount of the positive section 481(a) adjustment is ordinarily included in the Director's computation of the taxpayer's taxable income for the year of the method change. See section 5.04 of Rev. Proc. 2002-18, 2002-1 C.B. 678.

DISCUSSION

FACTS

The U.S. entities that own or use maquiladoras in Latin America can transfer tangible property to the maquiladora plant for use in the assembly process. This property is permitted under U.S. law to be transferred without incurring any export or import customs duties. Title to the property remains in the U.S. entities' name.

The U.S. entity transfers tangible property to a maquiladora in Latin America to be used in the maquiladora's assembly operation. None of this property is described in section 168(g)(4), which exempts certain property used outside of the U.S. from section 168(g)(1)(A).

The U.S. entity computes depreciation using the general depreciation system. The property is used predominantly outside the U.S. (physically located outside the U.S. during its use for more than 50 percent of the time) during the taxable year.

LEGAL ANALYSIS

Generally, I.R.C. section 168(a) allows U.S. persons to use, under the general depreciation system (as determined under IRC sections 168(b), 168(c), and 168(d)), an accelerated method of accounting for depreciation for tangible property except when otherwise provided in section 168. I.R.C. section 168(g)(1)(A) states in general that in the case of any tangible property which during the taxable year is used predominantly outside the U.S., the depreciation deduction provided by section 167(a) shall be determined under the alternative depreciation system (I.R.C. section 168(g)(2)).

Under I.R.C. section 168(g)(2), the alternative depreciation system is depreciation determined by using

- (A) the straight-line method (without regard to salvage value),
 - (B) the applicable convention determined under section 168(d),
- and

(C) a recovery period determined under the following table:

(i) Property not described in clause (ii) or (iii)	The class life.
(ii) Personal property with no class life	12 years.
(iii) Nonresidential real and residential rental property	40 years.
(iv) any railroad grading or tunnel bore	50 years.

IRC section 168(g)(3) and Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by, Rev. Proc. 88-22, 1988-1 C.B. 785, set out the class life referred to in section 168(g)(2).

Under the legislative history to this section, property that is used outside the United States for more than half of a taxable year is deemed to be used predominantly outside the United States. S. Rept. No. 313, 99th Cong., 2d Sess. 103 (1986). This is further supported by Rev. Rul. 90-9, 1990-1 C.B. 46, which provides that to determine whether property is used predominantly outside the United States, section 168(g) applies rules similar to those under former section 48(a)(2). Under that section and regulations, property located outside the United States for more than 50 percent of the year was considered to be used predominantly outside the United States. Treas. Reg. section 1.48-1(g)(1)(i); *Norfolk Southern Corp. v. Commissioner*, 104 T.C. 13, 43 (1995), and 98-1 U.S.T.C. ¶50,273; AFTR 2nd ¶11198 (4th Circuit).

Treasury Regulation § 1.168(i)-4, which was published on June 17, 2004 (TD 9132, 69 FR 33840), explains how to compute depreciation under section 168 for property for which the use changes in the hands of the same taxpayer. For example, if a taxpayer uses property predominantly in the United States in year 1 and, in year 2, uses the property predominantly outside the United States, a change in use occurs in year 2 when the taxpayer begins to use the property predominantly outside the United States. These regulations also provide that the determination of whether property is used predominantly outside the United States during a year is made in accordance with the “predominant use” test in Treasury Regulation § 1.48-1(g)(1)(i).

Treasury Regulation § 1.446-1(e)(2)(ii)(a) provides 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. Although a method of accounting may exist under this definition without a pattern of consistent treatment of an item, a method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of §1.446-1(e)(2)(ii)(a).

Temporary Treasury Regulation § 1.446-1T(e)(2)(ii)(d) provides the changes in depreciation that are, and are not, a change in method of accounting. This regulation

is effective for depreciable property placed in service by a taxpayer in a taxable year ending on or after December 30, 2003.

For depreciable property placed in service by a taxpayer in a taxable year ending before December 30, 2003, CC-2004-007 (January 28, 2004) and CC-2004-024 (July 12, 2004) provide that the Internal Revenue Service will not assert that a change in computing depreciation under, among other sections, § 168 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 I.R.C. § 446(e). To effect this change in computing depreciation for this property, CC-2004-007 and CC-2004-024 further provide that the taxpayer has a choice of (i) filing amended federal tax returns thereby treating the change as not a change in method of accounting, or (ii) filing a Form 3115 for the current taxable year thereby treating the change as a change in method of accounting. If the taxpayer chooses to file amended federal tax return(s), an adjustment under I.R.C. § 481 is neither permitted nor required.

I. R.C. Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is determined under a method of accounting different from the method used to determine taxable income for the preceding taxable year.

Generally, a taxpayer that is contacted for examination and required to change its method of accounting by the Service ("involuntary change") generally receives less favorable terms and conditions when the change results in a positive section 481(a) adjustment than the taxpayer would have received if it had filed an application to change its method of accounting ("voluntary change") before the Taxpayer was contacted for examination.

The IRS has issued guidance with respect to "involuntary" and "voluntary" change-of-accounting methods under I.R.C. sections 446 and 481. For "involuntary" change-of-accounting method, refer to Rev. Proc. 2002-18, 2002-1 C.B. 678. For "voluntary" change-of-accounting method, refer to Rev. Proc. 97-27, 1997-1 C.B. 680, as modified by Rev. Proc. 2002-19, 2002-13 I.R.B., and Rev. Proc. 2002-9, 2002-1 C.B. 327, as modified by Rev. Proc. 2004-11, 2004-3 I.R.B. 311, Rev. Proc. 2002-54, 2002-2 C.B. 432, and Rev. Proc. 2002-19, 2002-1 C.B. 696, and as modified and clarified by Ann. 2002-17, 2002-1 C.B. 561.

SETTLEMENT GUIDELINES

Issue 1

If the U.S. entity uses tangible property outside the U.S. for more than half of the taxable year, it is deemed to have been used predominantly outside the U.S., and therefore the entity is required to compute its depreciation deduction under the alternative depreciation system provided in I.R.C. section 168(g)(2).

The depreciation allowances for the property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the property as of the first day of each taxable year by the applicable depreciation rate for each taxable year under section 168. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined must be adjusted for a short taxable year, see Rev. Proc. 89-15 (1989-1 C.B. 816). The application of depreciation allowance computations are illustrated by the examples under Treasury Regulation 1.168(i)-(4)(d).

If a change in the use of property occurs during the placed-in-service year and the property continues to be owned by the same taxpayer, the depreciation allowance for that property for the placed-in-service year is determined by its primary use during that year. The primary use of property may be determined in any reasonable manner that is consistently applied to the taxpayer's property. The application of depreciation allowance computations are illustrated by the examples under Treasury Regulation 1.168(i)-(4)(e).

Issue 2

A (U.S. entity) change from the general depreciation system under IRC section 168 (a) to the alternative depreciation system under section 168 (g)(2) may constitute a change in method of accounting to which provisions of IRC sections 446 and 481 apply.

If a U.S. entity that was properly depreciating property under the general depreciation system transfers the property from the U. S. to a maquiladora that uses the property predominately outside the U.S., a change in use of property occurs. See Treasury Regulation § 1.168(i)-4(d). If the U.S. entity begins to use the alternative depreciation system of section 168 (g)(2) for this property for the first year the property is used predominately outside the U.S., no change in method of accounting is required because of this change in use. See Treasury Regulation §§1.446-1T(e)(2)(ii)(d)(3)(ii) and 1.168(i)-4(f).

Also, no change in method of accounting occurs if the U.S. entity uses the general depreciation system for the property the first year the property is used predominantly outside the U.S. and, before filing the tax return for the next year, the U.S. entity files an amended return for the first year the property is used predominantly outside the U.S. using the alternative depreciation system of IRC section 168(g)(2) for the property. See Rev. Rul. 72-491, 1972-2, C.B. 104; and Rev. Rul. 90-38, 1990-1, CB 57.

However, if the U.S. entity continues to use the general depreciation system of IRC section 168(a) (as determined under IRC sections 168(b), 168(c), and 168(d)) for the property on two or more consecutively filed tax returns for years beginning with the first year the property is used predominantly outside the U.S., the U.S. entity has adopted an erroneous method of accounting for depreciation of the property. Generally, a change from this erroneous method for depreciation to the alternative depreciation system of IRC section 168(g)(2) for a change in use of property occurring in a year ending on or after December 30, 2003 is a change in method of accounting to which the provisions of IRC sections 446 and 481 apply. See Treasury Regulation section 1.168(i)-4(g)(2). If the change in use of property occurs in a year ending before December 30, 2003, the Service will not assert that a change from the erroneous method for depreciation to the alternative depreciation system is a change in method of accounting. See Notice CC-2004-007 (January 28, 2004) and Notice CC-2004-024 (July 12, 2004).

If there is not a change in method of accounting, any adjustment made by the Service for a change from the erroneous method for depreciation to the alternative depreciation system is made in a manner consistent with a taxpayer amending its returns(s).

If there is a change in method of accounting, the net adjustment required under I.R.C. section 481(a) is computed as of the beginning of the year of the change in method of accounting. The positive section 481(a) adjustment (increase in income) is the difference between:

a) the total amount of the accelerated depreciation (as determined under IRC sections 168(b), 168(c), and 168(d)) for the depreciable property taken by the U.S. entity for years beginning with the first year the property was used predominantly outside the U.S. and before the year of the change in method of accounting,

and

b) the total amount of depreciation allowable for the depreciable property under the alternative depreciation system (as determined under I.R.C. section 168(g)(2)) to the U.S. entity for

years beginning with the first year the property is used predominately outside the U.S. and before the year of change in method of accounting.

The amount of the positive section 481(a) adjustment, however, must be adjusted for any corresponding change in the depreciation amount that is required to be capitalized by the U.S. entity under any provision of the Code (for example, capitalized to the cost of the U.S. entity's inventory under section 263A).

If you have any questions, please contact Appeals Maquiladora ISP Coordinator Jean Su Yang at 972-308-7295.