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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-138499-02

RIN 1545-BB05

Changes in Use under Section 168(i)(5)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the depreciation of property subject to section 168 of the Internal Revenue Code (MACRS property).

Specifically, these proposed regulations provide guidance on how to depreciate MACRS property for which the use changes in the hands of the same taxpayer. The proposed regulations reflect changes to the law made by the Tax Reform Act of 1986. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by October 20, 2003.

Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Wednesday, December 3, 2003, at 10 a.m., must be received by November 12, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-138499-02), room 5226, Internal Revenue Service, P. O. Box 7604, Ben Franklin Station, Washington, DC 20044.

Alternatively, submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG-138499-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or sent electronically,

via the IRS Internet site at: www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sara Logan, (202) 622-3110; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 to provide regulations under section 168(i)(5) of the Internal Revenue Code (Code). In addition, these proposed amendments provide change-in-use rules for assets in a general asset account under section 168(i)(4). Sections 168(i)(4) and 168(i)(5) were amended by section 201 of the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 2121).

Explanation of Provisions

Scope

The proposed regulations provide the rules for determining the annual depreciation allowance under section 168 for property for which the use changes in the hands of the taxpayer. Changes in use include a conversion of personal use property to a business or income-producing use, a conversion of MACRS property to personal use, or a change in use of MACRS property that results in a different recovery period, depreciation method, or both.

Conversion to Business or Personal Use

The proposed regulations provide that personal use property converted to business

or income-producing use is treated as being placed in service by the taxpayer on the date of the conversion. Thus, the property is depreciated by using the applicable depreciation method, recovery period, and convention prescribed under section 168 for the property beginning in the taxable year the change of use ("year of change") occurs. The depreciable basis of the property for the year of change is the lesser of its fair market value or adjusted depreciable basis at the time of the conversion.

A conversion of MACRS property from business or income-producing use to personal use is treated as a disposition of the property. Depreciation for the year of change is computed by taking into account the applicable convention. No gain, loss, or depreciation recapture is recognized upon the conversion. See Rev. Rul. 69-487 (1969-2 C.B. 165).

MACRS Property

Use Changes After Placed-in-service Year

The proposed regulations provide rules for MACRS property if a taxpayer changes the use of the property after the property's placed-in-service year but the property continues to be MACRS property in the hands of the taxpayer.

In general, the proposed regulations provide that a change in the use of MACRS property occurs when the primary use of the MACRS property in the taxable year is different from its primary use in the immediately preceding taxable year. A change in the use of MACRS property also occurs when a taxpayer begins or ceases to use MACRS property predominantly outside the United States, when the property changes to tax-exempt bond financed property, or when the property changes to or from tax-exempt use

property or imported property covered by an Executive order, during the taxable year. If a change in the use of MACRS property has occurred, the depreciation allowance for the MACRS property for the year of change is determined as though the change in the use of the MACRS property occurred on the first day of the year of change. The IRS and Treasury Department believe that this rule will help to simplify the computation of depreciation allowances in the year of change and subsequent taxable years. The IRS and Treasury Department invite comments on this rule and on a potential alternative rule that would treat a change in the use of MACRS property as occurring on the first day of the month in which the use changes and would allocate the depreciation allowance for that MACRS property for the year of change based on the number of full months of the old use and of the new use of the MACRS property during the year of change.

The proposed regulations also provide rules for determining the applicable depreciation method, recovery period, and convention used to determine the depreciation allowances for the MACRS property for the year of change and subsequent taxable years. If a change in the use of MACRS property results in a shorter recovery period and/or a more accelerated depreciation method (for example, MACRS property ceases to be used predominantly outside the United States), the adjusted depreciable basis of the property as of the beginning of the year of change is depreciated over the shorter recovery period and/or by the more accelerated depreciation method beginning with the year of change as though the MACRS property is first placed in service in the year of change. Under certain circumstances, this rule may adversely affect taxpayers. For example, under this rule, if a change in the use of MACRS property results in a shorter recovery period, a taxpayer must

depreciate that MACRS property over the new shorter recovery period even if the remaining portion of the original longer recovery period is less than the new shorter recovery period. To avoid this adverse effect, the proposed regulations allow a taxpayer to elect to continue to depreciate the MACRS property for which the new recovery period is shorter or a more accelerated method is allowed as though the change in use had not occurred.

If a change in the use of MACRS property results in a longer recovery period and/or slower depreciation method (for example, MACRS property begins to be used predominantly outside the United States), the adjusted depreciable basis of the property is depreciated over the longer recovery period and/or by the slower depreciation method beginning with the year of change as though the taxpayer originally placed the MACRS property in service with the longer recovery period and/or slower depreciation method. Accordingly, the adjusted depreciable basis of the MACRS property as of the beginning of the year of change is depreciated over the remaining portion of the new, longer recovery period as of the beginning of the year of change.

For MACRS property depreciated under the optional depreciation tables in Rev. Proc. 87-57 (1987-2 C.B. 687) before the change in use, the taxpayer may continue to depreciate the property under the tables after the change in use. However, the taxpayer is not required to do so. If the taxpayer desires to use the optional depreciation tables after a change in the use instead of the formulas (for example, see section 6 of Rev. Proc. 87-57 (1987-2 C. B. at 692)), the proposed regulations provide guidance on choosing the applicable optional depreciation table. If the change in use results in a longer recovery

period and/or a slower depreciation method, the proposed regulations also provide guidance on how to modify the calculation involved to compute the depreciation allowances beginning in the year of change.

If a change in the use of MACRS property results in a shorter recovery period and/or more accelerated depreciation method, the taxpayer may use the optional depreciation table that corresponds to the applicable depreciation method, recovery period, and convention, determined as though the property is placed in service in the year of change. Taxpayers should be aware that using this table will result in less depreciation than using the formulas, because the convention is factored into the optional depreciation tables, and taken into account in determining depreciation in the year of change. However, if the formulas are used, the convention is not taken into account in the year of change. The IRS and Treasury Department invite comments on this matter.

Use Changes During Placed-in-service Year

The proposed regulations provide rules for MACRS property if a change in the use occurs during the taxable year the property is placed-in-service and the property continues to be MACRS property in the hands of the taxpayer. If the use of MACRS property changes during its placed-in-service year, the depreciation allowance generally is determined by the primary use of the property during that taxable year. However, in determining whether MACRS property is used within or outside the United States during the placed-in-service year, the predominant use, instead of the primary use, of the MACRS property governs. Further, in determining whether MACRS property is tax-exempt use property or imported property covered by an Executive order during the placed-in-service

year, the use of the property at the end of the placed-in-service year governs. Moreover, MACRS property is tax-exempt bond financed property during the placed-in-service year if a tax-exempt bond for the MACRS property is issued during that year.

General Asset Accounts

Finally, the proposed regulations amend the final regulations under section 168(i)(4) (TD 8566, 59 FR 51369 (1994)) for property accounted for in a general asset account for which the use changes, resulting in a different recovery period and/or depreciation method. While this change in use does not cause or permit the revocation of the election to account for the property in a general asset account, the property generally is removed from its existing general asset account and placed in a separate general asset account. Because this rule would require taxpayers to track each property in a general asset account, the IRS and Treasury Department request comments on whether the IRS and Treasury should adopt a rule that disregards any change in the use of any MACRS property accounted for in a general asset account, except for a conversion to personal use.

Proposed Effective Date

These regulations are proposed to be applicable for any changes in the use of MACRS property in taxable years ending on or after the date of publication of the final regulations in the **Federal Register**. For any changes in use of MACRS property after December 31, 1986, in taxable years ending before the date of publication of the final regulations in the **Federal Register**, the IRS will allow any reasonable method of depreciating the property under section 168 in the year of change and the subsequent taxable years that is consistently applied to the MACRS property that changed use in the

hands of the taxpayer.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply to these regulations. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 3, 2003, beginning at 10:00 a.m., in room number 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to

enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 12, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Sara Logan, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

§1.168(i)-1 also issued under 26 U.S.C. 168(i)(4).

§1.168(i)-4 also issued under 26 U.S.C. 168(i)(5).

Par. 2. Sections 1.168(a)-1 and 1.168(b)-1 are added to read as follows:

§1.168(a)-1 Modified accelerated cost recovery system.

Section 168 determines the depreciation allowance for tangible property that is of a character subject to the allowance for depreciation provided in section 167(a) and that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143).

Except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule, the provisions of section 168 are mandatory for all eligible property. The allowance for depreciation under section 168 constitutes the amount of depreciation allowable under section 167(a). The determination of whether tangible property is property of a character subject to the allowance for depreciation is made under section 167 and the regulations thereunder. This section is effective as of the date of publication of the final regulations in the **Federal Register**.

§1.168(b)-1 Definitions.

(a) Definitions. For purposes of section 168 and the regulations thereunder, the following definitions apply:

(1) Depreciable property is property that is of a character subject to the allowance for depreciation as determined under section 167 and the regulations thereunder.

(2) MACRS property is tangible, depreciable property that is placed in service after

December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143), and subject to section 168, except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule.

(3) Unadjusted depreciable basis is the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under section 179, and for any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations thereunder (other than section 1016(a)(2) and (3)) (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)). For property subject to a lease, see section 167(c)(2).

(4) Adjusted depreciable basis is the unadjusted depreciable basis of the property less the adjustments described in section 1016(a)(2) and (3).

(b) Effective date. This section applies as of the date of publication of the final regulations in the **Federal Register**.

Par. 3. Section 1.168(i)-0 is amended by revising the entry for §1.168(i)-1(h)(2) to read as follows:

§1.168(i)-0 Table of contents for the general asset account rules.

* * * * *

§1.168(i)-1

(h) * * *

(2) Change in use results in a different recovery period and/or depreciation method.

* * * * *

Par. 4. Section 1.168(i)-1 is amended by:

1. Revising paragraph (b)(1).
2. Amending paragraph (c)(2)(ii) by:
 - a. Removing the language "and" from the end of paragraph (c)(2)(ii)(C).
 - b. Removing the period "." from the end of paragraph (c)(2)(ii)(D) and adding "; and" in its place.
 - c. Adding paragraph (c)(2)(ii)(E).
3. Removing the language "(h)(1) (conversion to personal use)" from paragraphs (d)(2) and (i) and adding "(h) (changes in use)" in its place.
4. Removing the language "the change in use occurs and" from the last sentence of paragraph (h)(1) and adding "the change in use occurs (the year of change) and" in its place.
5. Revising paragraph (h)(2).
6. Removing the language "(h)(1)" from paragraph (j) and adding "(h)" in its place.
7. Removing the language "(h)(1)" from paragraph (k)(1) and adding "(h)" in its place.
8. Revising paragraph (l).

The addition and revisions read as follows:

§1.168(i)-1 General asset accounts.

* * * * *

(b) * * *

(1) Unadjusted depreciable basis is the basis of an asset for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under section 179, and for any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations thereunder (other than section 1016(a)(2) and (3)) (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)). For property subject to a lease, see section 167(c)(2).

* * * * *

(c) * * *

(2) * * *

(ii) * * *

(E) Assets subject to paragraph (h)(2)(iii)(A) of this section (change in use results in a shorter recovery period and/or a more accelerated depreciation method) for which the depreciation allowance for the year of change is not determined by using an optional depreciation table must be grouped into a separate general asset account.

* * * * *

(h) * * *

(2) Change in use results in a different recovery period and/or depreciation method-
-(i) No effect on general asset account election. A change in the use described in

§1.168(i)-4(d) (change in use results in a different recovery period and/or depreciation method) of an asset in a general asset account shall not cause or permit the revocation of the election made under this section.

(ii) Asset is removed from the general asset account. Upon a change in the use described in §1.168(i)-4(d), the taxpayer must remove the asset from the general asset account as of the first day of the year of change and must make the adjustments to the general asset account described in paragraphs (e)(3)(iii)(C)(2) through (4) of this section. If, however, the result of the change in use is described in §1.168(i)-4(d)(3) (change in use results in a shorter recovery period and/or a more accelerated depreciation method) and the taxpayer elects to treat the asset as though the change in use had not occurred pursuant to §1.168(i)-4(d)(3)(ii), no adjustment is made to the general asset account upon the change in use.

(iii) New general asset account is established--(A) Change in use results in a shorter recovery period and/or a more accelerated depreciation method. If the result of the change in use is described in §1.168(i)-4(d)(3) (change in use results in a shorter recovery period and/or a more accelerated depreciation method) and adjustments to the general asset account are made pursuant to paragraph (h)(2)(ii) of this section, the taxpayer must establish a new general asset account for the asset in the year of change in accordance with the rules in paragraph (c) of this section, except that the adjusted depreciable basis of the asset as of the first day of the year of change is included in the general asset account. For purposes of paragraph (c)(2) of this section, the applicable depreciation method, recovery period, and convention are determined under §1.168(i)-4(d)(3)(i).

(B) Change in use results in a longer recovery period and/or a slower depreciation method. If the result of the change in use is described in §1.168(i)-4(d)(4) (change in use results in a longer recovery period and/or a slower depreciation method), the taxpayer must establish a separate general asset account for the asset in the year of change in accordance with the rules in paragraph (c) of this section, except that the unadjusted depreciable basis of the asset, and the greater of the depreciation of the asset allowed or allowable in accordance with section 1016(a)(2), as of the first day of the year of change are included in the newly established general asset account. Consequently, this general asset account as of the first day of the year of change will have a beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the general asset account. For purposes of paragraph (c)(2) of this section, the applicable depreciation method, recovery period, and convention are determined under §1.168(i)-4(d)(4)(ii).

* * * * *

(l) Effective date--(1) In general. Except as provided in paragraph (l)(2) of this section, this section applies to depreciable assets placed in service in taxable years ending on or after October 11, 1994. For depreciable assets placed in service after December 31, 1986, in taxable years ending before October 11, 1994, the Internal Revenue Service will allow any reasonable method that is consistently applied to the taxpayer's general asset accounts.

(2) Exceptions--(i) In general. Paragraphs (c)(2)(ii)(E) and (h)(2) of this section apply to any changes in the use of depreciable assets pursuant to §1.168(i)-4(d) in taxable years ending on or after the date of publication of the final regulations in the **Federal**

Register. For any changes in the use of depreciable assets as described in §1.168(i)-4(d) after December 31, 1986, in taxable years ending before the date of publication of the final regulations in the **Federal Register**, the Internal Revenue Service will allow any reasonable method that is consistently applied to the taxpayer's general asset accounts.

(ii) Change in method of accounting. If a taxpayer adopted a method of accounting for general asset account treatment due to a change in the use of depreciable assets and the method is not in accordance with the method of accounting provided in paragraphs (c)(2)(ii)(E) and (h)(2) of this section, a change to the method of accounting provided in paragraphs (c)(2)(ii)(E) and (h)(2) of this section is a change in method of accounting to which the provisions of sections 446(e) and 481 apply. For any taxable year ending on or after the date of publication of the final regulations in the **Federal Register**, a taxpayer changing its method of accounting in accordance with this paragraph (l)(2)(ii) must follow the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, for example, see Rev. Proc. 2002-9 (2002-1 C.B. 327) and §601.601(d)(2)(ii)(b) of this chapter). Because this change does not change the adjusted depreciable basis of the asset, the method change is made on a cut-off basis and, therefore, no adjustment under section 481(a) is required or allowed.

* * * * *

Par. 5. Section 1.168(i)-4 is added to read as follows:

§1.168(i)-4 Changes in use.

(a) Scope. This section provides the rules for determining the depreciation

allowance for MACRS property for which the use changes in the hands of the same taxpayer. The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a) for the year of change and any subsequent taxable year. For purposes of this section, the year of change is the taxable year in which a change in the use occurs.

(b) Conversion to business or income-producing use--(1) Depreciation deduction allowable. This paragraph (b) applies to property that is converted from personal use to use in a taxpayer's trade or business, or for the production of income, during a taxable year. This conversion includes property that was previously used by the taxpayer for personal purposes, including real property (other than land) that is acquired before 1987 and converted from personal use to business or income-producing use after 1986, and depreciable property that was previously used by a tax-exempt entity before it changed to a taxable entity. Upon a conversion to business or income-producing use, the depreciation allowance for the year of change and any subsequent taxable year is determined as though the property is placed in service by the taxpayer on the date on which the conversion occurs. Thus, the taxpayer may choose any applicable depreciation method, recovery period, and convention prescribed under section 168 for the property in the year of change, consistent with any election made under section 168 by the taxpayer for that year (see, for example, section 168(b)(5)). The depreciable basis of the property for the year of change is the lesser of its fair market value or its adjusted depreciable basis, as applicable, at the time of the conversion to business or income-producing use.

(2) Example. The application of this paragraph (b) is illustrated by the following

example:

Example. A, a calendar-year taxpayer, purchases a house in 1985 that she occupies as her principal residence. In February 2003, A ceases to occupy the house and converts it to residential rental property. At the time of the conversion to residential rental property, the house's fair market value (excluding land) is \$130,000 and adjusted depreciable basis attributable to the house (excluding land) is \$150,000. Pursuant to this paragraph (b), A is considered to have placed in service residential rental property in February 2003 with a depreciable basis of \$130,000. A depreciates the residential rental property under the general depreciation system by using the straight-line method, a 27.5-year recovery period, and the mid-month convention. This property is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). Thus, the depreciation allowance for the house for 2003 is \$4,137, after taking into account the mid-month convention ($(\$130,000 \text{ adjusted depreciable basis multiplied by the applicable depreciation rate of } 3.636\% (1/27.5)) \text{ multiplied by the mid-month convention fraction of } 10.5/12$). The amount of depreciation computed under section 168, however, may be limited under other provisions of the Internal Revenue Code, such as, section 280A.

(c) Conversion to personal use. The conversion of MACRS property from business or income-producing use to personal use during a taxable year is treated as a disposition of the property in that taxable year. The depreciation allowance for MACRS property for the year of change in which the property is treated as being disposed of is determined by first multiplying the adjusted depreciable basis of the property as of the first day of the year of change by the applicable depreciation rate for that taxable year (for further guidance, for example, see section 6 of Rev. Proc. 87-57 (1987-2 C. B. 687, 692), and §601.601(d)(2)(ii)(b) of this chapter). This amount is then multiplied by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service during the year of change (taking into account the applicable convention) and the denominator of which is 12. No depreciation deduction is allowable for MACRS property placed in service and disposed of in the same taxable

year. Upon the conversion to personal use, no gain, loss, or depreciation recapture under section 1245 or section 1250 is recognized. However, the provisions of section 1245 or section 1250 apply to any disposition of the converted property by the taxpayer at a later date.

(d) Change in use results in a different recovery period and/or depreciation method-

(1) In general. This paragraph (d) applies to a change in the use of MACRS property during a taxable year subsequent to the placed-in-service year, if the property continues to be MACRS property owned by the same taxpayer and, as a result of the change in use, has a different recovery period, a different depreciation method, or both. For example, this paragraph (d) applies to MACRS property that--

(i) Begins or ceases to be used predominantly outside the United States;

(ii) Results in a reclassification of the property under section 168(e) due to a change in the use of the property; or

(iii) Begins or ceases to be tax-exempt use property (as defined in section 168(h)).

(2) Determination of change in use--(i) In general. Except as provided in paragraph (d)(2)(ii) of this section, a change in the use of MACRS property occurs when the primary use of the MACRS property in the taxable year is different from its primary use in the immediately preceding taxable year. The primary use of MACRS property may be determined in any reasonable manner that is consistently applied to the taxpayer's MACRS property.

(ii) Alternative depreciation system property--(A) Property used within or outside the United States. A change in the use of MACRS property occurs when a taxpayer begins or

ceases to use MACRS property predominantly outside the United States during the taxable year. The determination of whether MACRS property is used predominantly outside the United States is made in accordance with the test in §1.48-1(g)(1)(i) for determining predominant use.

(B) Tax-exempt bond financed property. A change in the use of MACRS property occurs when the property changes to tax-exempt bond financed property, as described in section 168(g)(1)(C) and (g)(5), during the taxable year. For purposes of this paragraph (d), MACRS property changes to tax-exempt bond financed property when a tax-exempt bond is first issued after the MACRS property is placed in service. MACRS property continues to be tax-exempt bond financed property in the hands of the taxpayer even if the tax-exempt bond (including any refunding issue) is no longer outstanding or is redeemed.

(C) Other mandatory alternative depreciation system property. A change in the use of MACRS property occurs when the property changes to, or changes from, property described in section 168(g)(1)(B) (tax-exempt use property) or (D) (imported property covered by an Executive order) during the taxable year.

(iii) Change in use deemed to occur on first day of year. If a change in the use of MACRS property occurs under this paragraph (d)(2), the depreciation allowance for that MACRS property for the year of change is determined as though the use of the MACRS property changed on the first day of the year of change.

(3) Change in use results in a shorter recovery period and/or a more accelerated depreciation method--(i) Treated as placed in service in year of change--(A) In general. If the change in use results in the MACRS property changing to a shorter recovery period

and/or a depreciation method that is more accelerated than the method used for the MACRS property before the change in use, the depreciation allowances beginning in the year of change are determined as though the MACRS property is placed in service by the taxpayer in the year of the change in use.

(B) Computation of depreciation allowance. The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of each taxable year by the applicable depreciation rate for each taxable year. In determining the applicable depreciation rate for the year of change and subsequent taxable years, the taxpayer may choose any applicable depreciation method and recovery period prescribed under section 168 for the MACRS property in the year of change, consistent with any election made under section 168 by the taxpayer for that year (see, for example, section 168(b)(5)). If there is a change in the use of MACRS property, the applicable convention that applies to the MACRS property is the same as the convention that applied before the change in the use of the MACRS property. However, the depreciation allowance for the year of change for the MACRS property is determined without applying the applicable convention, unless the MACRS property is disposed of during the year of change. See paragraph (d)(5) of this section for the rules relating to the computation of the depreciation allowance under the optional depreciation tables. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(3)(i) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89-15 (1989-1 C.B. 816) and

§601.601(d)(2)(ii)(b) of this chapter).

(C) Special rules. MACRS property affected by this paragraph (d)(3)(i) is not eligible in the year of change for the election provided under section 168(f)(1), 179, or 1400L(f), or for the additional first-year depreciation deduction provided in section 168(k) or 1400L(b). For purposes of determining whether the mid-quarter convention applies to other MACRS property placed in service during the year of change, the unadjusted depreciable basis or the adjusted depreciable basis of MACRS property affected by this paragraph (d)(3)(i) is not taken into account.

(ii) Option to disregard change in use. In lieu of applying paragraph (d)(3)(i) of this section, the taxpayer may elect to determine the depreciation allowance as though the change in use had not occurred. The taxpayer elects this option by claiming on the taxpayer's timely filed (including extensions) income tax return for the year of change the depreciation allowance for the property as though the change in use had not occurred. See paragraph (g)(2) of this section for the manner for revoking this election.

(4) Change in use results in a longer recovery period and/or a slower depreciation method--(i) Treated as originally placed in service with longer recovery period and/or slower depreciation method. If the change in use results in a longer recovery period and/or a depreciation method for the MACRS property that is less accelerated than the method used for the MACRS property before the change in use, the depreciation allowances beginning with the year of change are determined as though the MACRS property had been originally placed in service by the taxpayer with the longer recovery period and/or the slower depreciation method.

(ii) Computation of the depreciation allowance. The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of each taxable year by the applicable depreciation rate for each taxable year. If there is a change in the use of MACRS property, the applicable convention that applies to the MACRS property is the same as the convention that applied before the change in the use of the MACRS property. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(4)(ii) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89-15 (1989-1 C.B. 816) and §601.601(d)(2)(ii)(b) of this chapter). See paragraph (d)(5) of this section for the rules relating to the computation of the depreciation allowance under the optional depreciation tables. In determining the applicable depreciation rate for the year of change and any subsequent taxable year--

(A) The applicable depreciation method is the depreciation method that would apply in the year of change and any subsequent taxable year for the MACRS property had the taxpayer used the longer recovery period and/or the slower depreciation method in the placed-in-service year of the property. If the 200- or 150-percent declining balance method would have applied in the placed-in-service year but the method would have switched to the straight line method in the year of change or any prior taxable year, the applicable depreciation method beginning with the year of change is the straight line method; and

(B) The applicable recovery period is either--

(1) The longer recovery period resulting from the change in use if the applicable depreciation method is the 200- or 150-percent declining balance method (as determined under paragraph (d)(4)(ii)(A) of this section) unless the recovery period did not change as a result of the change in use, in which case the applicable recovery period is the same recovery period that applied before the change in use; or

(2) The number of years remaining as of the beginning of each taxable year (taking into account the applicable convention) had the taxpayer used the longer recovery period in the placed-in-service year of the property if the applicable depreciation method is the straight line method (as determined under paragraph (d)(4)(ii)(A) of this section) unless the recovery period did not change as a result of the change in use, in which case the applicable recovery period is the number of years remaining as of the beginning of each taxable year (taking into account the applicable convention) based on the recovery period that applied before the change in use.

(5) Using optional depreciation tables--(i) Taxpayer not bound by prior use of table.
If a taxpayer used an optional depreciation table for the MACRS property before a change in the use, the taxpayer is not bound to use the appropriate new table for that MACRS property after the change in use (for further guidance, for example, see section 8 of Rev. Proc. 87-57 (1987-2 C.B. 687, 693) and §601.601(d)(2)(ii)(b) of this chapter). If the taxpayer chooses not to continue to use the optional depreciation table, the depreciation allowances for the MACRS property beginning in the year of change are determined under paragraph (d)(3)(i) or (4) of this section, as applicable.

(ii) Taxpayer chooses to use optional depreciation table after change in use. If the

taxpayer chooses to continue to use an optional depreciation table for the MACRS property after a change in the use, the depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined as follows:

(A) Change in use results in a shorter recovery period and/or a more accelerated depreciation method. If the change in use results in a shorter recovery period and/or a more accelerated depreciation method (as described in paragraph (d)(3)(i) of this section), the depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of the year of change by the annual depreciation rate for each recovery year (expressed as a decimal equivalent) specified in the appropriate optional depreciation table. The appropriate optional depreciation table for the MACRS property is based on the depreciation system, depreciation method, recovery period, and convention applicable to the MACRS property in the year of change as determined under paragraph (d)(3)(i) of this section. The depreciation allowance for the year of change for the MACRS property is determined by taking into account the applicable convention (which is already factored into the optional depreciation tables). If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(5)(ii)(A) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89-15 (1989-1 C.B. 816) and §601.601(d)(2)(ii)(b) of this chapter).

(B) Change in use results in a longer recovery period and/or a slower depreciation

method--(1) Determination of the appropriate optional depreciation table. If the change in use results in a longer recovery period and/or a slower depreciation method (as described in paragraph (d)(4)(i) of this section), the depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by choosing the optional depreciation table that corresponds to the depreciation system, depreciation method, recovery period, and convention that would have applied to the MACRS property in the placed-in-service year had that property been originally placed in service by the taxpayer with the longer recovery period and/or the slower depreciation method. If there is a change in the use of MACRS property, the applicable convention that applies to the MACRS property is the same as the convention that applied before the change in the use of the MACRS property. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(5)(ii)(B) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89-15 (1989-1 C.B. 816) and §601.601(d)(2)(ii)(b) of this chapter).

(2) Computation of the depreciation allowance. The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are computed by first determining the appropriate recovery year in the table identified under paragraph (d)(5)(ii)(B)(1) of this section. The appropriate recovery year for the year of change is the year that corresponds to the year of change. For example, if the recovery year for the year of change would have been Year 4 in the table that applied before the change in the use of the MACRS property, then the recovery year for the year of change is Year 4 in the table identified under paragraph (d)(5)(ii)(B)(1) of this section. Next, the

annual depreciation rate (expressed as a decimal equivalent) for each recovery year is multiplied by a transaction coefficient. The transaction coefficient is the formula $(1 / (1 - x))$ where x equals the sum of the annual depreciation rates from the table identified under paragraph (d)(5)(ii)(B)(1) of this section (expressed as a decimal equivalent) for the taxable years beginning with the placed-in-service year of the MACRS property through the taxable year immediately prior to the year of change. The product of the annual depreciation rate and the transaction coefficient is multiplied by the adjusted depreciable basis of the MACRS property as of the beginning of the year of change.

(6) Examples. The application of this paragraph (d) is illustrated by the following examples:

Example 1. Change in use results in a shorter recovery period and/or a more accelerated depreciation method and optional depreciation table is not used--(i) X, a calendar-year corporation, places in service in 1998 equipment at a cost of \$100,000 and uses this equipment from 1998 through 2002 primarily in its A business. X depreciates the equipment for 1998 through 2002 under the general depreciation system as 7-year property by using the 200-percent declining balance method (which switched to the straight-line method in 2002), a 7-year recovery period, and a half-year convention. Beginning in 2003, X primarily uses the equipment in its B business. As a result, the classification of the equipment under section 168(e) changes from 7-year property to 5-year property and the recovery period of the equipment under the general depreciation system changes from 7 years to 5 years. The depreciation method does not change. On January 1, 2003, the adjusted depreciable basis of the equipment is \$22,311. X depreciates its 5-year recovery property placed in service in 2003 under the general depreciation system by using the 200-percent declining balance method and a 5-year recovery period. X does not use the optional depreciation tables.

(ii) Under paragraph (d)(3)(i) of this section, X's allowable depreciation deduction for the equipment for 2003 and subsequent taxable years is determined as though X placed the equipment in service in 2003 for use primarily in its B business. The depreciable basis of the equipment as of January 1, 2003, is \$22,311 (the adjusted depreciable basis at January 1, 2003). Because X does not use the optional depreciation tables, the depreciation allowance for 2003 (the deemed placed-in-service year) for this equipment only is computed without taking into account the half-year convention. This

equipment is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). Thus, X's allowable depreciation deduction for the equipment for 2003 is \$8,924 (\$22,311 adjusted depreciable basis at January 1, 2003, multiplied by the applicable depreciation rate of 40% (200/5)). X's allowable depreciation deduction for the equipment for 2004 is \$5,355 (\$13,387 adjusted depreciable basis at January 1, 2004 multiplied by the applicable depreciation rate of 40% (200/5)).

(iii) Alternatively, under paragraph (d)(3)(ii) of this section, X may elect to disregard the change in use and, as a result, may continue to treat the equipment as though it is used primarily in its A business. If the election is made, X's allowable depreciation deduction for the equipment for 2003 is \$8,924 (\$22,311 adjusted depreciable basis at January 1, 2003, multiplied by the applicable depreciation rate of 40% (1/2.5 years remaining at January 1, 2003)). X's allowable depreciation deduction for the equipment for 2004 is \$8,925 (\$13,387 adjusted depreciable basis at January 1, 2004 multiplied by the applicable depreciation rate of 66.67% (1/1.5 years remaining at January 1, 2004)).

Example 2. Change in use results in a shorter recovery period and/or a more accelerated depreciation method and optional depreciation table is used—(i) Same facts as in Example 1, except that X used the optional depreciation tables for computing depreciation for 1998 through 2002. Pursuant to paragraph (d)(5) of this section, X chooses to continue to use the optional depreciation table for the equipment. X does not make the election provided in paragraph (d)(3)(ii) of this section to disregard the change in use.

(ii) In accordance with paragraph (d)(5)(ii)(A) of this section, X must first identify the appropriate optional depreciation table for the equipment. This table is table 1 in Rev. Proc. 87-57 because the equipment will be depreciated in the year of change (2003) under the general depreciation system using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention (which is the convention that applied to the equipment in 1998). This equipment is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). For 2003, X multiplies its adjusted depreciable basis in the equipment as of January 1, 2003, of \$22,311, by the annual depreciation rate in table 1 for recovery year 1 for a 5-year recovery period (.20), to determine the depreciation allowance of \$4,462. For 2004, X multiplies its adjusted depreciable basis in the equipment as of January 1, 2003, of \$22,311, by the annual depreciation rate in table 1 for recovery year 2 for a 5-year recovery period (.32), to determine the depreciation allowance of \$7,140.

Example 3. Change in use results in a longer recovery period and/or a slower depreciation method—(i) Y, a calendar-year corporation, places in service in January 2001, equipment at a cost of \$100,000 and uses this equipment in 2001 and 2002 only within the United States. Y depreciates the equipment for 2001 and 2002 under the general depreciation system by using the 200-percent declining balance method, a 5-year

recovery period, and a half-year convention. Beginning in 2003, Y uses the equipment predominantly outside the United States. As a result of this change in use, the equipment is subject to the alternative depreciation system beginning in 2003. Under the alternative depreciation system, the equipment is depreciated by using the straight-line method and a 9-year recovery period. The adjusted depreciable basis of the equipment at January 1, 2003, is \$48,000.

(ii) Pursuant to paragraph (d)(4) of this section, Y's allowable depreciation deduction for 2003 and subsequent taxable years is determined as though the equipment had been placed in service in January 2001, as property used predominantly outside the United States. In determining the applicable depreciation rate for 2003, the applicable depreciation method is the straight-line method and the applicable recovery period is 7.5 years, which is the number of years remaining at January 1, 2003, for property placed in service in 2001 with a 9-year recovery period (taking into account the half-year convention). Thus, the depreciation allowance for 2003 is \$6,398 (\$48,000 adjusted depreciable basis at January 1, 2003, multiplied by the applicable depreciation rate of 13.33% (1/7.5 years)). The depreciation allowance for 2004 is \$6,398 (\$41,602 adjusted depreciable basis at January 1, 2004, multiplied by the applicable depreciation rate of 15.38% (1/6.5 years remaining at January 1, 2004)).

Example 4. Change in use results in a longer recovery period and/or a slower depreciation method and optional depreciation table is used--(i) Same facts as in Example 3, except that Y used the optional depreciation tables for computing depreciation in 2001 and 2002. Pursuant to paragraph (d)(5) of this section, Y chooses to continue to use the optional depreciation table for the equipment.

(ii) In accordance with paragraph (d)(5)(ii)(B) of this section, Y must first determine the appropriate optional depreciation table for the equipment pursuant to paragraph (d)(5)(ii)(B)(1) of this section. This table is table 8 in Rev. Proc. 87-57, which corresponds to the alternative depreciation system, the straight-line method, a 9-year recovery period, and the half-year convention (because Y depreciated 5-year property in 2001 using a half-year convention). Next, Y must determine the appropriate recovery year in table 8. Because the year of change is 2003, the depreciation allowance for the equipment for 2003 is determined using recovery year 3 of table 8. For 2003, Y multiplies its adjusted depreciable basis in the equipment as of January 1, 2003, of \$48,000, by the product of the annual depreciation rate in table 8 for recovery year 3 for a 9-year recovery period (.1111) and the transaction coefficient $[1/(1-(.0556+.1111))]$, which equals 1.200, to determine the depreciation allowance of \$6,399. For 2004, Y multiplies its adjusted depreciable basis in the equipment as of January 1, 2003, of \$48,000, by the product of the annual depreciation rate in table 8 for recovery year 4 for a 9-year recovery period (.1111) and the transaction coefficient (1.200), to determine the depreciation allowance of \$6,399.

(e) Change in the use of MACRS property during the placed-in-service year--(1) In general. Except as provided in paragraph (e)(2) of this section, if a change in the use of MACRS property occurs during the placed-in-service year and the property continues to be MACRS property 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 MACRS property may be determined in any reasonable manner that is consistently applied to the taxpayer's MACRS property. For purposes of this paragraph (e), the determination of whether the mid-quarter convention applies to any MACRS property placed in service during the year of change is made in accordance with §1.168(d)-1.

(2) Alternative depreciation system property--(i) Property used within and outside the United States. The depreciation allowance for the placed-in-service year for MACRS property that is used within and outside the United States is determined by its predominant use during that year. The determination of whether MACRS property is used predominantly outside the United States during the placed-in-service year shall be made in accordance with the test in §1.48-1(g)(1)(i) for determining predominant use.

(ii) Tax-exempt bond financed property. The depreciation allowance for the placed-in-service year for MACRS property that changes to tax-exempt bond financed property, as described in section 168(g)(1)(C) and (g)(5), during that taxable year is determined under the alternative depreciation system. For purposes of this paragraph (e), MACRS property changes to tax-exempt bond financed property when a tax-exempt bond is first issued after the MACRS property is placed in service. MACRS property continues to be

tax-exempt bond financed property in the hands of the taxpayer even if the tax-exempt bond (including any refunding issue) is not outstanding at, or is redeemed by, the end of the placed-in-service year.

(iii) Other mandatory alternative depreciation system property. The depreciation allowance for the placed-in-service year for MACRS property that changes to, or changes from, property described in section 168(g)(1)(B) (tax-exempt use property) or (D) (imported property covered by an Executive order) during that taxable year is determined under--

(A) The alternative depreciation system if the MACRS property is described in section 168(g)(1)(B) or (D) at the end of the placed-in-service year; or

(B) The general depreciation system if the MACRS property is not described in section 168(g)(1)(B) or (D) at the end of the placed-in-service year.

(3) Examples. The application of this paragraph (e) is illustrated by the following examples:

Example 1. (i) Z, a utility and calendar-year corporation, places in service on January 1, 2003, equipment at a cost of \$100,000. Z uses this equipment in its combustion turbine production plant for 4 months and then uses the equipment in its steam production plant for the remainder of 2003. Z's combustion turbine production plant assets are classified as 15-year property and are depreciated by Z under the general depreciation system using a 15-year recovery period and the 150-percent declining balance method of depreciation. Z's steam production plant assets are classified as 20-year property and are depreciated by Z under the general depreciation system using a 20-year recovery period and the 150-percent declining balance method of depreciation. Z uses the optional depreciation tables. The equipment is qualified property for purposes of section 168(k)(1).

(ii) Pursuant to this paragraph (e), Z must determine depreciation based on the primary use of the equipment during the placed-in-service year. Z has consistently determined the primary use of all of its MACRS property by comparing the number of full

months in the taxable year during which a MACRS property is used in one manner with the number of full months in that taxable year during which that MACRS property is used in another manner. Applying this approach, Z determines the depreciation allowance for the equipment for 2003 is based on the equipment being classified as 20-year property because the equipment was used by Z in its steam production plant for 8 months in 2003. If the half-year convention applies in 2003, the appropriate optional depreciation table is table 1 in Rev. Proc. 87-57, which is the table for MACRS property subject to the general depreciation system, the 150-percent declining balance method, a 20-year recovery period, and the half-year convention. Thus, the depreciation allowance for the equipment for 2003 is \$32,625, which is the total of \$30,000 for the additional 30-percent first-year depreciation deduction allowable (the unadjusted depreciable basis of \$100,000 multiplied by .30), plus \$2,625 for the 2003 depreciation allowance on the remaining basis of \$70,000 [(the unadjusted depreciable basis of \$100,000 less the additional first-year depreciation deduction of \$30,000) multiplied by the annual depreciation rate of .0375 in table 1 for recovery year 1 for a 20-year recovery period].

Example 2. I, a calendar year corporation, places in service on January 1, 2003, several computers at a total cost of \$100,000. I uses these computers within the United States for 3 months in 2003 and then moves and uses the computers outside the United States for the remainder of 2003. Pursuant to §1.48-1(g)(1)(i), the computers are considered as used predominantly outside the United States in 2003. As a result, for 2003, the computers are required to be depreciated under the alternative depreciation system of section 168(g) with a recovery period of 5 years pursuant to section 168(g)(3)(C). I uses the optional depreciation tables. If the half-year convention applies in 2003, the appropriate optional depreciation table is table 8 in Rev. Proc. 87-57, which is the table for MACRS property subject to the alternative depreciation system, the straight-line method, a 5-year recovery period, and the half-year convention. Thus, the depreciation allowance for the computers for 2003 is \$10,000, which is equal to the unadjusted depreciable basis of \$100,000 multiplied by the annual depreciation rate of .10 in table 8 for recovery year 1 for a 5-year recovery period. Because the computers are required to be depreciated under the alternative depreciation system in their placed-in-service year, the computers are not eligible for the additional first year depreciation deduction provided by section 168(k).

(f) No change in accounting method. A change in computing the depreciation allowance in the year of change for property subject to this section results from a change in underlying facts and, thus, is not a change in method of accounting under section 446(e).

(g) Effective date--(1) In general. This section applies to changes in the use of MACRS property in taxable years ending on or after the date of publication of the final

regulations in the **Federal Register**. For changes in the use of MACRS property after December 31, 1986, in taxable years ending before the date of publication of the final regulations in the **Federal Register**, the Internal Revenue Service will allow any reasonable method of depreciating the property under section 168 in the year of change and the subsequent taxable years that is consistently applied to any property that changed use in the hands of the taxpayer.

(2) Change in method of accounting--(i) In general. If a taxpayer adopted a method of accounting for depreciation due to a change in the use of MACRS property and the method is not in accordance with the method of accounting for depreciation provided in this section, a change to the method of accounting for depreciation provided in this section is a change in method of accounting to which the provisions of sections 446(e) and 481 and the regulations thereunder apply. Also, a revocation of the election provided in paragraph (d)(3)(ii) of this section to disregard a change in the use is a change in method of accounting to which the provisions of sections 446(e) and 481 and the regulations thereunder apply.

(ii) Automatic consent to change method of accounting. For any taxable year ending on or after the date of publication of the final regulations in the **Federal Register**, a taxpayer changing its method of accounting in accordance with this paragraph (g)(2) must follow the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, for example, see Rev. Proc. 2002-9 (2002-1 C.B. 327) and §601.601(d)(2)(ii)(b) of this chapter).

Any change in method of accounting made under this paragraph (g)(2) must be made using an adjustment under section 481(a).

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