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MEMORANDUM FOR BETTIE RICCA, CC:LM:MCT:WAS

FROM: Kathy Reed
Senior Technician Reviewer, CC:PSI:6

SUBJECT: Closing Agreement

This Chief Counsel Advice comments on a proposed closing agreement. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

B =

C =

D =

This memorandum expresses our concerns about the proposed classification of certain assets as 5-year property in the proposed closing agreement with B. The proposed agreement provides for the classification of certain assets placed in service by B from C through the taxable year ended D, for purposes of determining depreciation deductions under the general depreciation system in § 168(a). Pursuant to the proposed agreement, depreciable assets related to B's wellness center for its employees, B's distribution centers storing the products manufactured by it, and B's kitchens for testing its products will be classified as 5-year property. For the reasons discussed below, we believe that these depreciable assets are classified as 7-year property instead of 5-year property for purposes of § 168(a).

Section 167(a) provides a depreciation allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income.

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in § 168(a); and (2) the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

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The classification of depreciable property subject to § 168 is determined under § 168(e) by reference to class life or by statute. Pursuant to § 168(e)(1), property with a class life of more than 4 years but less than 10 years is classified as 5-year property, and property with a class life of 10 years or more but less than 16 years is classified as 7-year property.

Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former § 167(m) as if it were in effect, and the taxpayer were an elector. Prior to its revocation, § 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations sets out the method for asset classification under former § 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities. In the case of a lessor of property, § 1.167(a)-11(e)(3)(iii) provides that unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for such property is determined as if the property were owned by the lessee. However, in the case of an asset guideline class based upon the type of property (such as trucks or railroad cars) as distinguished from the activity in which used, the property is classified without regard to the activity of the lessee.

Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowances under § 168. The revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The same item of depreciable property can be described in both an asset category (that is, asset classes 00.11 through 00.4) and an activity category (that is, asset classes 01.1 through 80.0), in which case the item is classified in the asset category. See Norwest Corporation & Subsidiaries v. Commissioner, 111 T.C. 105 (1998) (item described in both an asset and an activity category should be placed in the asset category).

Rev. Rul. 77-476, 1977-2 C.B. 5, holds that an oil pipeline owned by an electric utility company and used to transport oil between the company's dock and its inland generating facility is operated for the sole purpose of supplying fuel for the taxpayer's own use in producing electricity and, therefore, is included in asset class 49.13, Electric Utility Steam Production Plant, rather than in asset class 46.0, Pipeline Transportation.

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Under a class life depreciation regime, property is classified according to the industrial or commercial activity in which the taxpayer is engaged, except for the types of assets that are usually used in many different activities (that is, assets described in asset classes 00.11 through 00.4 of Rev. Proc. 87-56). Where a taxpayer is engaged in more than one industrial or commercial activity, the cost of assets used in each activity are to be separated and depreciation deductions calculated separately for each activity. If an item of property is used in two industrial or commercial activities that correspond to two activities, depreciation deductions for the item are calculated based on the activity in which the item is primarily used. If two identical items (for example, two forklifts) are primarily used in each of two separate industrial or commercial activities of a taxpayer, depreciation deductions for each item are computed based on the activity in which the item is primarily used.

Besides classifying property by reference to class life, certain property is classified by statute regardless of its class life. For example, any qualified technological equipment as defined in § 168(i)(2) is classified as 5-year property pursuant to § 168(e)(3)(B). Also, pursuant to § 168(e)(3)(C)(ii), any property that does not have a class life and is not otherwise classified under § 168(e)(2) or (3) is classified as 7-year property.

In the present case, we understand that B is engaged in a farming business, as defined in § 263A(e)(4), and manufactures food and meat products. The asset class of Rev. Proc. 87-56 generally applicable to B's farming business is asset class 01.1, Agriculture, which has a class life of 10 years. The asset class of Rev. Proc. 87-56 generally applicable to B's manufacturing business is asset class 20.4, Manufacture of Other Food and Kindred Products, which has a class life of 12 years. Based on the class lives of assets included in asset class 01.1 or 20.4, such assets are classified as 7-year property under § 168(e)(1) and, therefore, have a recovery period of 7 years for purposes of the general depreciation system of § 168(a).

We understand that the depreciable assets related to B's wellness center for its employees, B's distribution centers storing the products manufactured by it, and B's kitchens for testing its products were determined to be 5-year property because the assets are included in asset class 57.0, Distributive Trades and Services, of Rev. Proc. 87-56, or do not have a class life. We disagree. Assuming these assets do not have a class life, the 5-year property classification is inappropriate pursuant to § 168(e)(3)(C)(ii). This section provides that any property that does not have a class life and is not otherwise classified under § 168(e)(2) or (3), is classified as 7-year property. Further, as discussed below, we believe that these assets are included in the asset class associated with B's farming or manufacturing business thereby resulting in the assets being classified as 7-year property.

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With respect to the distribution centers, B stores the products that it manufactures in these distribution centers before such products are sold by B to others. B owns and operates these distribution centers for its own use. Consequently, B is not engaged in the wholesale distributive trade business. See Rev. Rul. 77-476. Therefore, B's assets related to the distribution centers are not included in asset class 57.0 of Rev. Proc. 87-56. Instead, these assets are included in the asset class(es) associated with B's food and meat manufacturing business.

Similarly, the assets related to B's kitchens for testing products are not included in asset class 57.0 of Rev. Proc. 87-56. B's kitchens for testing products are connected with its food and meat manufacturing business, and these test kitchens are for B's own use. Consequently, the test kitchens are part and parcel of B's food and meat manufacturing business. Accordingly, B's test kitchen assets are included in the asset class(es) associated with B's food and meat manufacturing business.

Moreover, the assets related to B's wellness center are not included in asset class 57.0 of Rev. Proc. 87-56. This center is operated by B for the use of its own employees. B is not engaged in the business of providing the personal and professional services associated with the wellness center. If the wellness center is used by B's employees in its farming and manufacturing businesses, B's wellness center assets are included in the asset class(es) associated with B's farming or manufacturing business according to the assets' primary use.

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

Please call if you have any further questions.

Kathy Reed
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