OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
July 17, 2001

Number: **200144031**
Release Date: 11/2/2001
CC:PSI:6
WTA-N-1211412-01
UILC: 168.20-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
APPEALS OFFICER
AREA

FROM: PAUL F. KUGLER
ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES)
CC:PSI

SUBJECT: Class life of

This Chief Counsel Advice responds to your memorandum dated March 29, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

DISCLOSURE STATEMENT

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.

LEGEND

Taxpayer =

ISSUE

For purposes of depreciation classification, is includible in asset class 20.4 or asset class 20.5 of Rev. Proc. 87-56, 1987-2 C.B. 674?

CONCLUSION

is includible in asset class 20.4 for depreciation classification purposes.

FACTS

Taxpayer is a corporation engaged in the manufacturing and distribution business. Taxpayer uses returnable to market its products. Although many different sizes of are used, all are collectively referred to as

Taxpayer's was initially made of . During World War II Taxpayer used for its . Taxpayer converted to in the 1950's.

During the manufacturing process, Taxpayer's is filled with and automatically stacked on pallets. The size of the determines how many can be stacked on a pallet. Forklift trucks move the to storage pending shipment to customers.

Taxpayer contends that, because of technological advancements in design over the years and changes in customer preferences, earlier generations of have become obsolete. In addition, because the is outside Taxpayer's control over of the time, a significant percentage of Taxpayer's is lost or damaged annually. For these reasons, Taxpayer estimates that the average life of its is about years. On the other hand, Examination contends that has a 20-year useful life.

Since Taxpayer has argued that a 3-year recovery period is appropriate for its . Prior to this time Taxpayer recovered the cost of its over 7 years.

LAW AND ANALYSIS

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

For purposes of either section 168(a) or 168(g), the applicable recovery period is determined by reference to class life or by statute. 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 section 167(m) as if it were in effect and the taxpayer were an elector. Prior to its revocation, section 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 section 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.

Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowances under section 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 (furniture and fixtures) should be placed in the asset category). The business activity asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 20.4, Manufacture of Other Food and Kindred Products, includes assets used in the production of foods and beverages not included in certain other asset classes not pertinent here. Assets in this class have a recovery period of 7 years for purposes of section 168(a) and 12 years for purposes of section 168(g).

Asset class 20.5, Manufacture of Food and Beverages--Special Handling Devices, includes assets defined as specialized materials handling devices such as returnable pallets, palletized containers, and fish processing equipment including boxes, baskets, carts, and flaking trays used in activities as defined in certain asset classes, including asset class 20.4. Assets in this class have a recovery period of 3 years for purposes of section 168(a) and 4 years for purposes of section 168(g).

In the present case Taxpayer's business activity is defined in asset class 20.4 and Taxpayer's is not included in the asset classes consisting of specific assets used in all business activities. The question presented is whether Taxpayer's is included in the subsidiary asset class 20.5. To answer this question we must consider the historical evolution of subsidiary asset classes. We note at the outset that under current depreciation law the actual useful life of Taxpayer's property does not determine its asset class.

Prior to the advent of class life depreciation regimes, the most recent of which is set forth in section 168 (MACRS), depreciation deductions were calculated based on taxpayer-specified useful lives and salvage values using prescribed depreciation methods. This "facts and circumstances" depreciation regime was rife with factual disputes between taxpayers and the Service over useful life and salvage value. In 1931 the Service issued Bulletin "F", a compendium of useful lives, as a guide for taxpayers and revenue agents. This document provided useful lives for thousands of assets organized by industry. A revised and significantly enlarged Bulletin "F" was issued in 1942. With respect to a -year life was provided for machinery and equipment and a -year life was provided for . (We note that at the time these documents were prepared was made of rather than).

In order to provide taxpayers with a greater degree of certainty regarding the amount of their depreciation deductions, Rev. Proc. 62-21, 1962-2 C.B. 418, was published setting forth new guidelines and rules for depreciation. The revenue procedure states that the guideline lives apply to broad classes of assets rather than to individual assets. A taxpayer's depreciable property was to be depreciated under a single asset class unless the property was specifically listed elsewhere in the revenue procedure. The guideline lives were divided into four groups. Group Three consisted of asset classes for manufacturing activities. Food and beverage manufacturers were included in Class 7. A 12-year life was provided for this class. Group One included assets used by business in general. Class 5 of Group One was comprised of so-called "subsidiary assets." This class included "equipment such as jigs, dies, molds, and patterns: returnable containers and pallets; crockery, glassware, linens, and silverware; and other subsidiary assets which are commonly and properly accounted for separately from those assets falling within the guideline classes in Group Two, Three, or Four." 1962-2 C.B. at 420. The revenue procedure states that subsidiary assets are more usually and properly accounted for under a method of accounting other than a method of depreciation using a life expressed in terms of years. A life was not provided for these assets.

Rev. Proc. 62-21 was supplemented by Rev. Proc. 62-21 Supplement II, 1963-2 C.B. 744, which consisted of Questions and Answers. Answer 74 provides that the Subsidiary Assets guideline class in Group One is relatively limited in scope and that, generally, useful life measured in years is not appropriate for the assets in the

class because factors other than wear, tear, and decay have a greater weight in determining the proper method and period of cost recovery. Answer 74 goes on to provide that whenever depreciation, with the useful life measured in years, is the usual method of accounting for the assets for tax purposes, the assets will properly fall in a guideline class other than Subsidiary Assets. 1963-2 C.B. at749.
Section 1.167(a)-11 of the Income Tax Regulations provided a depreciation system, elective by the taxpayer, based on class lives, asset guideline classes, and asset depreciation ranges (CLADR). Section 1.167(a)-11(b)(4)(iii)(b) provides that, for purposes of CLADR, property shall be included in the asset guideline class for the activity in which the property is primarily used even though the activity is insubstantial in relation to all the taxpayer's activities.

Section 1.167(a)-11(b)(5)(vii) provides that the term "subsidiary assets" includes jigs, dies, molds, returnable containers, glassware, silverware, textile mill cam assemblies, and other equipment included in Group One, Class 5, of Rev. Proc. 62-21. The regulation further provides that these assets are usually and properly accounted for separately from other property and under a method of depreciation not expressed in terms of years.

Section 1.167(a)-11(b)(4)(ii) provides that asset guideline classes and periods, and asset depreciation ranges, will from time to time be established, supplemented, revised, and published in the Internal Revenue Bulletin.

Rev Proc 71-25, 1971-2 C.B. 553, was published to set forth the asset guideline classes, asset guideline periods, and asset depreciation ranges referred to in section 1.167(a)-11. Asset class 20.4 of the revenue procedure is the direct predecessor of asset class 20.4 of Rev. Proc. 87-56. The asset guideline period for this class was 12 years. A separate class for subsidiary assets was not provided.

Rev. Proc. 72-10, 1972-1 C.B. 721, was published to restate under the rules authorized by section 167(m) (ADR), the asset guideline classes, depreciation periods, and depreciation ranges referred to in section 1.167(a)-11(b)(4). The description of asset class 20.4 in Rev. Proc. 72-10 is identical to the description in Rev. Proc. 71-25. Similarly, no subsidiary assets class was provided.

Section 167(m) of the Code was enacted by the Revenue Act of 1971 (Act). The legislative history of the Act indicates that Congress was concerned about the lack of subsidiary asset classes under the ADR system. Congress noted that under the 1962 guidelines subsidiary assets had a depreciation class separate from that provided for other major items of equipment in the respective industry. The legislative history states that a separate class was provided for subsidiary assets because in some cases their useful lives were substantially shorter than other assets used in the industry. Under the ADR system, however, subsidiary assets are grouped in a class with other major assets in the industry, which class had in some cases a substantially longer life. Congress indicated that Treasury was studying the lives of subsidiary assets and considering whether to develop a separate class with a shorter life for these assets. S. Rep. No. 437, 92nd Cong., !st Sess. at 49-50 (1971).

Rev. Proc. 74-30, 1974-2 C.B. 483, established subsidiary asset classes for various industries. Asset class 20.5 was established for subsidiary assets used in the food and beverage manufacturing industry. An asset guideline period of 4 years was provided for this class. The description of the asset class included a sentence providing that “special handling devices” are specifically designed for the handling of particular products and have no significant utilitarian value and cannot be adapted to further or different use after changes are made in the design of the particular product handled by the special devices. This sentence was not included when Rev. Proc. 87-56 was published. With this exception, the description of asset class 20. 5 in Rev. Proc. 74-30 is the same as the description of the asset class in Rev. Proc. 87-56. In addition, while Rev. Proc. 62-21 included returnable containers in its description of subsidiary assets, neither Rev. Proc. 74-30 nor Rev. Proc. 87-56 includes this term in asset class 20.5.

Our review of the evolution of the subsidiary asset classes indicates that, like the other asset classes, they were established taking into account recognized industry practices and realities. When the subsidiary asset classes were created they were intended to include assets that had shorter useful lives than the other major assets used in a particular industry. In addition, assets that were normally depreciated by a particular industry using a time-based depreciation method (that is, a depreciation method expressed in terms of years) were not intended to be included in a subsidiary asset class. Only assets meeting both of these criteria can be depreciated as subsidiary assets. Accordingly, Taxpayer's   is not includible in the subsidiary asset class unless   was considered a short-lived asset in the   industry and normally depreciated using a non time-based depreciation method.

As the legislative history discussed above makes clear, Congress was concerned that taxpayers in particular industries were not electing to use the ADR depreciation system because they could recover the cost of their subsidiary assets more rapidly using the facts and circumstances depreciation regime. The record of this case does not convince us that   were ever considered to be short-lived assets in the   industry. While Bulletin "F" provides a   year life for   , presumably   is more durable. Our presumption is buttressed by Examination's finding that the useful life of in the industry is over 20 years. With regard to depreciation methodology, there is no information in the record suggesting that non time-based depreciation methods have ever been used by the   industry to depreciate   . Section 1.167(a)-11(b)(5)(vii) provides that subsidiary assets are properly accounted for using non time-based depreciation methods. has historically been depreciated over a period of years. Therefore, does not meet the requirements for inclusion in asset class 20.5.

Taxpayer argues that its is described, and therefore includible, in asset class 20.5 because its are specialized materials handling devices, palletized containers, and returnable containers. We disagree with this contention. are not specialized materials handling devices. is not the only that can be stored in . More importantly, as noted in Rev. Proc. 74-30, specialized materials handling devices are assets whose useful life is impacted by changes in the materials or products being handled by the assets. is not a product likely to undergo a change in design that would render existing obsolete. Further, the expanding industry provides a ready market for unwanted . In addition, we are uncertain whether assets that number in the can be considered to be specialized materials handling devices. Nor are palletized containers. An asset is not a palletized container simply because it is transported on pallets. The term "palletized" refers to the design of the asset rather than to its means of transport. With regard to the other descriptive terms in asset class 20.5, "returnable pallets" and "fish processing equipment" clearly have no application to . As previously mentioned, the term "returnable containers" has never been used in asset class 20.5. While this term was used in Rev. Proc. 62-21, this revenue procedure has been explicitly superseded. See Rev. Proc. 72-10 (superseding Rev. Proc. 71-25 and Rev. Proc. 62-10); Rev. Proc. 71-25 (superseding Rev. Proc. 62-21). Section 1.167(a)-11(b)(3)(ii) indicates that the asset classes set forth in revenue procedures are subject to revision by subsequent revenue procedures. Accordingly, we conclude that Taxpayer's is not described in asset class 20.5 and, therefore, is includible in asset class 20.4 for depreciation purposes.

Finally, Taxpayer has alleged that Rev. Rul. 58-77, 1958-1 C.B. 118, concerns . The revenue ruling involves the manufacturer of a product sold to customers "in large durable containers with a useful life of approximately 10 years." While this revenue ruling does not address asset classification for depreciation purposes, it should be noted that the durable containers at issue were cable spools rather than as alleged by Taxpayer. We note that in

the petitioner, a , depreciated its over a 20-year period.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

If you have any questions regarding this Field Service Advice, please call (202) 622-3110.

PAUL F. KUGLER
Associate Chief Counsel
(Passthroughs & Special Industries)
By:____________________
Charles B. Ramsey
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)