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to: Associate Area Counsel-Los Angeles (Group 2), CC:LBI:CTM:LA:2

from: Branch Chief, Branch 7, Income Tax & Accounting, CC:ITA:B07

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subject: Request for advice with regard to calculation of depreciation

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1) How is depreciation calculated under § 167 or § 168, or amortization calculated under § 167, for an asset under either the foreign sales corporation ("FSC") regime or the extraterritorial income ("ETI") exclusion provisions?

2) Is a change in when the depreciation or amortization of such an asset that is allocated to the exempt foreign trade income under the FSC regime or is subject to the ETI exclusion provisions is recovered a change in method of accounting under § 446(e) of the Internal Revenue Code? If it is, is such a change covered by the List of Automatic Changes in Rev. Proc. 2015-14, 2015-5 I.R.B. 450, for which the automatic change procedures in Rev. Proc. 2015-13, 2015-5 I.R.B. 419, apply?

CONCLUSIONS

1) The determination of how depreciation is calculated under § 167 or § 168, or amortization is calculated under § 167, for an asset subject to either the FSC regime or ETI exclusion provisions hinges on: a) the type of asset, b) whether the annual depreciation or amortization deductions are determined by using the adjusted basis or unadjusted basis of the asset, and c) whether the asset's

recovery period or useful life ended before or after the end of the transaction(s) that qualified for FSC or ETI exclusion treatment, as applicable. Scenarios 1-4 examine specifically how depreciation is calculated based upon how these three factors change.

2) A change in when the depreciation or amortization of such an asset that is allocated to the exempt foreign trade income under the FSC regime or subject to the ETI exclusion provisions is recovered is a change in method of accounting. This change in method of accounting is not covered by the List of Automatic Changes in Rev. Proc. 2015-14 for which the automatic change procedures in Rev. Proc. 2015-13 apply.

FACTS

Scenario 1: A taxpayer had a wholly-owned subsidiary that qualified as a FSC under former §§ 921–927. The FSC owned tangible property ("Asset A") that it leased to an unrelated, non-U.S. entity pursuant to a 4-year lease that was entered into on January 1, 1997, and ended on December 31, 2000.[1] The contract that gave rise to the lease did not include a purchase option, renewal option, or replacement option. Under § 1.923-1T(b)(1)(ii) and former §§ 923(a)(2) and 291(a)(4), the FSC treated 30 percent of its foreign trade income as exempt foreign trade income not subject to taxation. Pursuant to former § 921(b) and to § 265(a)(1), the FSC did not reduce its taxable income by deducting expenses allocable to the exempt foreign trade income.

The taxpayer's subsidiary placed in service Asset A, a depreciable tangible asset that has a class life of 5 years, on January 1, 1997. The subsidiary depreciated this asset pursuant to §§ 167(a) and 168(g). The subsidiary did not use the optional depreciation tables pursuant to § 8 of Rev. Proc. 87-57, 1987-2 C.B. 687, and, thus, depreciated the adjusted basis of Asset A in accordance with §§ 4, 5, and 6 of Rev. Proc. 87-57. The recovery period of Asset A ended after December 31, 2000, which is the lease expiration date.

For purposes of calculating taxable income, the subsidiary only deducted 70 percent of Asset A's total depreciation consistent with former § 921(b) and with § 265(a)(1). The

[1] For purposes of all four scenarios, assume that all requirements of the FSC regime or the ETI exclusion provisions, as applicable, have been met, including that the transaction was properly characterized as a lease, rather than as a financing or a service that would not qualify for either FSC or ETI treatment. *See, e.g.*, § 924(a) (limiting FSC treatment to certain sales, leases, and services) ; *see also Tidewater Inc. and Subsidiaries and Tidewater Foreign Sales Corporation v. United States*, 565 F. 3d 299 (5th Cir. 2009), *aff'g* No. 06-875, 2007 U.S. Dist. LEXIS 77147 (E.D. La. October 17, 2007), *action on dec.*, 2010-22 (June 1, 2010) (IRS agreeing with the Fifth Circuit that § 7701(e) applies to determine a single character for a transaction subject to the FSC regime, but nonacquiescing in the court's determination under the § 7701(e) factors that the transaction at issue (a time charter of an ocean-going vessel) was a sublease rather than a service).

subsidiary did not deduct Asset A's depreciation allocated to exempt foreign trade income (*i.e.*, the other 30 percent of the asset's total depreciation).

The taxpayer timely filed a Form 3115, Application for Change in Method of Accounting, requesting permission to change the subsidiary's method of accounting for Asset A's depreciation allocated to exempt foreign trade income, beginning with the taxable year beginning January 1, 2015 (year of change). The subsidiary owns Asset A as of January 1, 2015, the first day of the year of change. Under the subsidiary's present method of accounting, the subsidiary determines the annual depreciation deductions of Asset A under § 168(g) by reducing its unadjusted basis for both the depreciation allocated to the non-exempt foreign trade income and the depreciation allocated to the exempt foreign trade income. As a result, the depreciation of Asset A that is allocated to the exempt foreign trade income (*i.e.*, 30 percent of total depreciation) is not recovered by the subsidiary until it disposes of Asset A. Under the subsidiary's proposed method of accounting, the subsidiary will determine the annual depreciation deductions of Asset A under § 168(g) by reducing its unadjusted basis for only the depreciation allocated to the non-exempt foreign trade income (*i.e.*, 70 percent of the total depreciation). As a result, the unadjusted basis of Asset A is fully recovered by the subsidiary through depreciation deductions.

<u>Scenario 2</u>: The facts are the same as Scenario 1, except that the subsidiary used the applicable optional depreciation table to determine the annual depreciation deductions for Asset A pursuant to § 8 of Rev. Proc. 87-57.

<u>Scenario 3</u>: The facts are the same as Scenario 1, except that the lease was for 11 years and ended on December 31, 2007. Thus, Asset A's recovery period ended prior to December 31, 2007, which is the lease expiration date.

<u>Scenario 4</u>: A taxpayer owns a motion picture film that qualified for benefits under the ETI exclusion provisions of former § 114. Under former §§ 114(a) and (b) and 941(a)(1)(A), the taxpayer calculated ETI exclusions based on qualified foreign trade income equal to 30 percent of its foreign sale and leasing income from the motion picture film. Pursuant to former § 114(c), the taxpayer did not reduce its taxable income by deducting expenses allocable to the extraterritorial income.

The taxpayer placed the film in service in 2003 and depreciated the film pursuant to the income forecast method under § 167(g). The taxpayer licensed its motion picture film to an unrelated, non-U.S. entity pursuant to a 15-year license that was entered into on the film's placed-in-service date in 2003. The contract that gave rise to the license did not include a purchase option, renewal option, or replacement option. The taxable year provided in § 167(g)(1)(C) ended prior to the expiration of the license.

For purposes of calculating taxable income, the taxpayer only deducted 70 percent of the film's total depreciation consistent with former § 114(c).[2] The taxpayer did not deduct the film's depreciation subject to the ETI exclusion provisions (*i.e.*, the other 30 percent of the film's total depreciation).

The taxpayer timely filed a Form 3115 requesting permission to change its method of accounting for the film's depreciation disallowed under former § 114(c), beginning with the taxable year beginning January 1, 2015 (year of change). The taxpayer owns this film as of January 1, 2015, the first day of the year of change. Under the taxpayer's present method of accounting, the adjusted basis of the film that is allocable to its depreciation disallowed under former § 114(c) (*i.e.*, the other 30 percent of the film's total depreciation) is not deducted until the taxpayer disposes of the film. Under the taxpayer's proposed method of accounting, the adjusted basis of the film that is allocable to its depreciation disallowed under former § 114(c) will be recovered in accordance with § 167(g)(1)(C).

LAW AND ANALYSIS

Issue 1

Section 167(a) provides that there is allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or held for the production of income.

Section 167(c)(1) provides, in general, that the basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property is the adjusted basis provided in § 1011, for the purposes of determining the gain on the sale or other disposition of such property. *See also* § 1.167(g)-1 of the Income Tax Regulations.

Section 1011 provides, in general, that the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under § 1012 or other applicable sections of subchapters O, C, K, and P), adjusted as provided in § 1016.

Section 1012 provides, in general, that the basis of property shall be the cost of such property.

Section 1016(a)(2) provides, in part, that proper adjustment in respect of the property shall be made for the exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount: (A) allowed as deductions in computing taxable income, and (B) resulting (by reason of the deductions so allowed) in a reduction for any

[2] The legislative history explained: "Because U.S. income tax principles generally deny deductions for expenses related to exempt income, otherwise deductible expenses that are allocated to qualifying foreign trade income generally are disallowed." S. Rep. No. 106-416, p.6 (2000)

taxable year of the taxpayer's taxes under subtitle A of the Code, but not less than the amount allowable under subtitle A of the Code or prior income tax laws.

In CBS Corp. v. United States, 105 Fed. Cl. 74 (2012), the petitioner had two wholly-owned FSCs, each of which purchased an airplane and leased such airplane to an unrelated third party. As such, 30 percent of the depreciation deductions taken by the FSCs were allocable to exempt foreign trade income and were disallowed for purposes of calculating taxable income. Later, each FSC sold its airplane to an unrelated third party and calculated its gain by subtracting from the airplane's basis both the depreciation allocated to non-exempt foreign trade income and the depreciation allocated to exempt foreign trade income. The petitioner then sought a refund, claiming that it had incorrectly reduced the adjusted basis in the airplane by the depreciation amounts allocated to exempt foreign trade income (but correctly reduced the adjusted basis in the airplane by the depreciation amounts allocated to the non-exempt foreign trade income).

Because the FSC regime allocated deductions to exempt foreign trade income and because deductions allocable to tax-exempt income are disallowed under § 265(a)(1), the court held that 30 percent of the aircraft's depreciation deductions were not "allowable" deductions under § 1016(a)(2). Thus, each airplane's adjusted basis is not reduced by the 30 percent of the airplane's depreciation deductions allocated to exempt foreign trade income under the FSC regime. Rather, the adjusted basis of each airplane should be reduced under § 1016(a)(2) by only the 70 percent of the airplane's depreciation deductions allocated to non-exempt foreign trade income under the FSC regime.

Both the FSC and ETI exclusion provisions provide tax benefits with respect to foreign trading gross receipts. *See generally* former §§ 114; 921-927; and 941-943. The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ("ETI Act") repealed the FSC provisions and enacted the ETI exclusion provisions. Pub. L. No. 106-519, 114 Stat. 2423, §§ 2 and 3 (2000). Section 5(a) of the ETI Act provides that the ETI exclusion provisions generally apply to "transactions after September 30, 2000" ("ETI effective date"). The legislative history further clarifies that the ETI exclusion provisions are "effective for transactions *entered into* after September 30, 2000." (emphasis added). S. Rep. No. 106-416, p.20 (2000); *see also* §§ 2.02 and 6.03 of Rev. Proc. 2001-37, 2001-1 C.B. 1327. For purposes of the FSC and ETI exclusion provisions, "transaction" means any sale, exchange, or other disposition; lease[3] or rental; and furnishing of services. Former §§ 927(d)(2)(A) and 943(b)(1).

Section 5(c)(1) of the ETI Act contains transition rules that delay the application

[3] As used in this memorandum, the term "lease" includes rentals, subleases, licenses, and sublicenses. *See* § 1.924(a)-1T(a)(2) of the temporary Income Tax Regulations; *see also* S. Rep. No. 106-416, p.8 ("Gross receipts from the lease or rental of qualifying foreign trade property include gross receipts from the license of qualifying foreign trade property.").

of the ETI exclusion provisions to certain transactions notwithstanding the ETI effective date. Section 5(c)(1) of the ETI Act provides in relevant part:

> In the case of a FSC (as so defined) in existence on September 30, 2000, and at all times thereafter, the amendments made by this Act shall not apply to any transaction in the ordinary course of trade or business involving a FSC which occurs—
>
> (A) before January 1, 2002. . . .

Section 5(c)(2) of the ETI Act allows a taxpayer to elect to apply the ETI exclusion provisions to any transaction that would have been subject to the FSC provisions by reason of § 5(c)(1) of the ETI Act. The § 5(c)(2) election applies on a transaction-by-transaction basis and is "effective for the taxable year for which made and all subsequent taxable years. . . ." *See also* § 6.04 of Rev. Proc. 2001-37.

The American Jobs Creation Act of 2004 ("AJCA") generally repealed the ETI exclusion provisions. Pub. L. No. 108-357, 118 Stat. 1418, § 101(a) and (b). Section 101(c) of the AJCA provides that the general repeal of the ETI exclusion provisions "shall apply to transactions after December 31, 2004" ("ETI repeal date").

The Service interprets the ETI effective date such that the FSC provisions generally apply to transactions entered into before October 1, 2000, and the ETI exclusion provisions generally apply to transactions entered into after September 30, 2000, subject to various other rules. Accordingly, in the case of a lease entered into before October 1, 2000, that met all the requirements under the FSC regime, all of the income received from that lease qualifies for FSC treatment regardless of when it is received. Similarly, in the case of a lease entered into after September 30, 2000, but before January 1, 2005,[4] that met all the requirements under the ETI exclusion provisions, all of the income received from that lease qualifies for ETI exclusions regardless of when it is received (except in the case of a lease entered into before January 1, 2002, which would not qualify for ETI exclusions unless an election is made pursuant to § 5(c)(2) of the ETI Act and which, in the absence of such election, would qualify for FSC treatment provided that all the requirements of the FSC regime are met). The determination of when a sale or lease is entered into within the meaning of § 5(a) of the ETI Act requires an analysis of the surrounding facts and circumstances on a case-by-case basis.

[4] Notably, in the case of transactions entered into during 2005 or 2006 and not pursuant to a binding contract meeting certain requirements, income from such transactions qualifies for only a reduced exclusion and only to the extent that the income is recognized during those years. *See* Pub. L. No. 108-357, 118 Stat. 1418, § 101(d).

Scenarios 1, 2, and 3

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 determining depreciation allowances. One method is the general depreciation system in § 168(a) and the other method is the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using an applicable depreciation method, recovery period, and convention.

Rev. Proc. 87-57 provides guidance in computing depreciation allowances for tangible property under § 168. This revenue procedure describes the applicable depreciation methods, applicable recovery periods, and applicable conventions that must be used in computing depreciation allowances under § 168. Sections 2-7 of this revenue procedure prescribe the manner of computing depreciation allowances. Section 8 of the revenue procedure contains various tables that may be used by certain taxpayers in lieu of computing allowances in the manner described in §§ 2-7.

Section 6.03 of Rev. Proc. 87-57 provides that the depreciation allowance for a full taxable year (that is, a taxable year of 12 full months) is computed by applying the applicable depreciation rate to the unrecovered basis of the property for each taxable year. For this purpose, the unrecovered basis of the property is the cost or other basis of the property adjusted for depreciation previously allowed or allowable and for all other applicable adjustments under § 1016 or any other provision of law. The determination of the applicable depreciation rate under each applicable depreciation method is described in §§ 6.04 (declining balance method), 6.05 (straight line method), and 6.06 (declining balance method switching to straight line method) of Rev. Proc. 87-57.

Section 8 of Rev. Proc. 87-57 allows taxpayers to use optional depreciation tables in computing annual depreciation allowances under § 168. Pursuant to § 8.01 of Rev. Proc. 87-57, the optional depreciation tables may be used for any item of property placed in service in a taxable year. Section 8.01 of Rev. Proc. 87-57 also provides that for all items of property placed in service in a taxable year for which the optional depreciation tables are not used, depreciation allowances must be computed in the manner prescribed in §§ 2-7 of Rev. Proc. 87-57.

Section 8.02 of Rev. Proc. 87-57 provides that the optional depreciation tables specify schedules of annual depreciation rates to be applied to the unadjusted basis of property in each taxable year. If a taxpayer uses a table to compute the annual depreciation allowance for any item of property, the taxpayer must use the table to compute the annual depreciation allowances for the entire recovery period of such property. However, a taxpayer may not continue to use the table if there are any adjustments to the basis of the property for reasons other than (1) depreciation allowed or allowable or (2) an addition or an improvement to such property that is subject to depreciation as a separate item of property. Taxpayers use the appropriate table for any property based

on the depreciation system, the applicable depreciation method, the applicable recovery period, and the applicable convention.

Under Scenarios 1, 2, and 3, the taxpayer had a wholly-owned subsidiary that was a FSC. This subsidiary placed in service Asset A, a depreciable tangible asset, on January 1, 1997, and leased Asset A to an unrelated, non-U.S. entity pursuant to a lease that was entered into on January 1, 1997. This subsidiary depreciated Asset A pursuant to §§ 167(a) and 168(g) using a recovery period of 5 years, which is Asset A's class life.[5] For purposes of calculating taxable income, the subsidiary only deducted 70 percent of Asset A's total depreciation. The subsidiary did not deduct Asset A's annual depreciation deductions allocable to exempt foreign trade income (*i.e.*, the other 30 percent of the asset's total depreciation). Pursuant to CBS Corp., Asset A's depreciation deductions allocable to exempt foreign trade income are not "allowable" for purposes of § 1016(a)(2) and, therefore, do not reduce Asset A's unadjusted basis. Rather, the unadjusted basis of Asset A is reduced only by the depreciation deductions allocable to the asset's non-exempt foreign trade income (*i.e.*, 70 percent of the asset's total depreciation).

Pursuant to Rev. Proc. 87-57, the annual depreciation deductions for tangible property under § 168(g) are determined by using the property's unrecovered basis or its unadjusted basis, depending on whether the taxpayer is using an optional depreciation table to determine the depreciation for that property. For this purpose, § 6.03 of Rev. Proc. 87-57 provides that the unrecovered basis of the property is the cost or other basis of the property adjusted for depreciation previously allowed or allowable and for all other applicable adjustments under § 1016 or any other provision of law. In other words, unrecovered basis is the same as adjusted basis.

Scenario 1 Depreciation Calculation

Under Scenario 1, the FSC determined the annual depreciation deductions for Asset A under § 168(g) in accordance with §§ 4, 5, and 6 of Rev. Proc. 87-57 and, thus, did not use the optional depreciation tables pursuant to § 8 of Rev. Proc. 87-57. As a result, the annual depreciation deductions of Asset A are determined by using Asset A's unrecovered (adjusted) basis. Because the unrecovered basis of Asset A for each taxable year takes into account only those depreciation deductions that are allowed or allowable under § 1016(a)(2), the unrecovered basis of Asset A is not reduced by the 30 percent of its annual depreciation deductions allocable to exempt foreign trade income. Further, because the recovery period of Asset A ended after the expiration of the lease (*i.e.*, after December 31, 2000), the FSC is able to fully recover the unadjusted basis of Asset A through depreciation deductions. Example 1 in the ATTACHMENT illustrates the calculation of these annual depreciation deductions.

[5] For purposes of Scenarios 1 through 3, assume § 168(g)(3)(A) does not apply.

Scenario 2 Depreciation Calculation

Under Scenario 2, the FSC determined the annual depreciation deductions for Asset A under § 168(g) by using the applicable optional depreciation table pursuant to § 8 of Rev. Proc. 87-57. Section 8.01 of Rev. Proc. 87-57 provides that the optional depreciation tables specify schedules of annual depreciation rates to be applied to the unadjusted basis of the property. Because the unadjusted basis of the property does not take into account depreciation deductions regardless of whether they are allowed or allowable under § 1016(a)(2), the depreciation amounts allocable to exempt foreign trade income are not recovered under the optional depreciation tables.

Section 8.02 of Rev. Proc. 87-57 provides that if a taxpayer uses an optional depreciation table to compute the annual depreciation allowance for any item of property, the taxpayer must use the table to compute the annual depreciation allowances for the entire recovery period of such property unless there are any adjustments to the basis of the property for reasons other than, among other things, depreciation allowed or allowable. In this case, the subsidiary reduces the unadjusted basis of Asset A for both the depreciation allocable to the non-exempt foreign trade income and the depreciation allocable to the exempt foreign trade income. In effect, the subsidiary treats both the depreciation allocable to the non-exempt foreign trade income and the depreciation allocable to the exempt foreign trade income as the depreciation allowable under § 1016(a)(2). Now, the subsidiary wants to treat only the depreciation allocable to the non-exempt foreign trade income as the depreciation allowable under § 1016(a)(2) in accordance with CBS Corp. As a result, the subsidiary is changing the amount of depreciation allowable for Asset A. Accordingly, the subsidiary must continue to use the optional depreciation table to compute the annual depreciation deductions for Asset A.

Thus, even though the subsidiary only deducted 70 percent of the asset's total depreciation pursuant to former § 921(b) and to § 265(a)(1), the adjusted basis allocable to depreciation disallowed under former § 921(b) and under § 265(a)(1) may not be recovered until the subsidiary disposes of Asset A. Example 2 in the ATTACHMENT illustrates the calculation of these annual depreciation deductions.

Scenario 3 Depreciation Calculation

Just as in Scenario 1, any depreciation deductions excluded under former § 921(b) and under § 265(a)(1) do not constitute allowable depreciation deductions for purposes of § 1016(a)(2) so that an asset's basis under § 1011 is not reduced by the depreciation deductions allocable to exempt foreign trade income. In Scenario 3, however, Asset A's recovery period ended prior to the expiration of the lease (*i.e.*, before December 31, 2007). Accordingly, there is no opportunity to recover the depreciation deductions allocable to exempt foreign trade income for the final year of the recovery period through a depreciation deduction. As a result, the depreciation deduction for the final year of Asset A's recovery period that is allocable to exempt foreign trade income is not

recovered until the subsidiary disposes of Asset A. Example 3 in the ATTACHMENT illustrates the calculation of these annual depreciation deductions.

Scenario 4

Section 167(g) allows a taxpayer to determine the depreciation deduction allowable under § 167(a) for the property listed in § 167(g)(6) by using the income forecast method. A taxpayer using the income forecast method under § 167(g) generally computes the depreciation allowances each year based upon the ratio of current year income to forecasted total income from the property. Section 167(g)(1)(C) provides that the depreciation deduction under the income forecast method for the 10th taxable year beginning after the taxable year in which the property was placed in service shall be equal to the adjusted basis of such property as of the beginning of such 10th taxable year. Section 167(g) generally applies to property placed in service after September 13, 1995.

The treatment of depreciation deductions under the ETI exclusion provisions is materially similar to the treatment of depreciation deductions under the FSC regime. Whereas under the FSC regime former § 921(b) required allocation of a portion of depreciation deductions to exempt foreign trade income and those deductions were then disallowed pursuant to § 265(a), under the ETI exclusion provisions, former § 114(c) both allocated a portion of depreciation deductions to extraterritorial income that is excluded from gross income and disallowed those deductions. Thus, the court's analysis in CBS Corp. similarly applies to depreciation deductions allocable to excluded ETI. Accordingly, any depreciation deductions excluded under former § 114(c) do not constitute allowable depreciation deductions for purposes of § 1016(a)(2). As a result, an asset's basis under § 1011 is not reduced by the depreciation deductions allocated to excluded ETI under former § 114(c).

Under Scenario 4, the taxpayer owns a motion picture film that qualified for benefits under the ETI exclusion provisions. The taxpayer placed the film in service in 2003, and licensed it to an unrelated, non-U.S. entity pursuant to a 15-year license entered into on the film's placed-in-service date. The taxpayer depreciated the film pursuant to the income forecast method under § 167(g). For purposes of calculating taxable income, the taxpayer only deducted 70 percent of the film's total depreciation consistent with the allocation required by former § 114(c). The taxpayer did not deduct the film's depreciation allocable to excluded ETI (*i.e.*, the other 30 percent of the film's total depreciation). Pursuant to CBS Corp., the film's depreciation deductions allocable to excluded ETI are not "allowable" for purposes of § 1016(a)(2) and, therefore, do not reduce the film's unadjusted basis. Rather, the unadjusted basis of the film is reduced only by 70 percent of the film's total depreciation.

Pursuant to § 167(g)(1)(C), the depreciation deduction under the income forecast method for the 10th taxable year beginning after the taxable year in which the property was placed in service shall be equal to the adjusted basis of such property as of the

beginning of such 10th taxable year. As a result, the depreciation deductions under the income forecast method that are allocable to exempt foreign trade income under the FSC regime or excluded ETI are recovered through depreciation deductions for the 10th taxable year beginning after the taxable year in which the property was placed in service. However, if such taxable year ends prior to the expiration of the transaction(s) that qualified for FSC or ETI exclusion treatment, as applicable, the depreciation deduction for that final year is subject to the FSC or ETI exclusion provisions, as applicable, and, as a result, the depreciation deduction for that final year that is allocable to exempt foreign trade income or excluded ETI is not recovered until the property is disposed of.

Under Scenario 4, the 10th taxable year beginning after the taxable year in which the film was placed in service ends prior to the expiration of the license of the motion picture film. Accordingly, there is no opportunity to recover the depreciation deductions allocable to excluded ETI for that taxable year through a depreciation deduction. As a result, the depreciation deduction for the 10th taxable year beginning after the taxable year in which the film was placed in service that is allocable to excluded ETI is not recovered until the taxpayer disposes of the motion picture film. Example 4 in the ATTACHMENT illustrates the calculation of these annual depreciation deductions.

Issue 2

Section 446(e) and § 1.446-1(e)(2)(i) provide, in general, that a taxpayer who changes the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books shall, before computing its taxable income under the new method, secure the consent of the Commissioner of Internal Revenue.

Section 1.446-1(e)(2)(ii)(*a*) provides that a change in the method of accounting includes, in relevant part, a change in the treatment of any material item used in the taxpayer's overall plan of accounting. Section 1.446-1(e)(2)(ii)(*a*) further provides that a material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime taxable income. If the practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the taxable year(s) in which the item is taken into account, it involves timing and is therefore a method of accounting. *See* § 2.01(1) of Rev. Proc. 2015-13.

Section 1.446-1(e)(2)(ii)(*b*) provides that a change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit).

A taxpayer recovers the unadjusted basis of a depreciable or amortizable asset through depreciation or amortization deductions, and if not fully depreciated or amortized, upon the disposition of the asset.

Under Scenarios 1-4, the taxpayer has a depreciable asset with an adjusted basis remaining after the end of the asset's recovery period or useful life. This adjusted basis is the amount of the asset's total depreciation deductions that were disallowed under former § 114(c) or former § 921(b) and under § 265(a)(1). The taxpayer currently recovers that adjusted basis upon the disposition of the asset. Except for Scenario 2, the taxpayer can change to recover some of, or all, the asset's adjusted basis through depreciation deductions and, where the taxpayer can recover only some of the asset's adjusted basis through depreciation deductions, the taxpayer will recover the remaining adjusted basis upon the disposition of the asset. As a result, the taxpayer's lifetime taxable income is not permanently affected and, thus, the taxpayer's requested change is a change in method of accounting.

This change in method of accounting, however, is not described in the depreciation automatic changes listed in §§ 6.01 and 6.17 of Rev. Proc. 2015-14 or in §§ 6.01 and 6.17 of the APPENDIX of Rev. Proc. 2011-14, 2011-4 I.R.B. 330, the predecessor to Rev. Proc. 2015-14. While § 6.01 of Rev. Proc. 2015-14 (*i.e.*, designated automatic accounting method change number 7) covers changes in methods of accounting for depreciation, it does not apply in Scenarios 1-4 because the taxpayer is not making a change in method of accounting under § 1.446-1(e)(2)(ii)(*d*). Instead, the taxpayer is making a change in method of accounting under § 1.446-1(e)(2)(ii)(*a*). Further, § 6.01 of Rev. Proc. 2015-14 does not apply in Scenario 4 because the property is subject to § 167(g). Sections 6.01(1)(a)(ii) and (1)(c)(iv) of Rev. Proc. 2015-14. Section 6.17 of Rev. Proc. 2015-14 (*i.e.*, designated automatic accounting method change number 107) does not apply in Scenarios 1-4 because the taxpayer has not disposed of the depreciable asset. Further, § 6.17 of Rev. Proc. 2015-14 does not apply in Scenarios 2-4 because the taxpayer did not claim less than the depreciation allowable for the asset. Sections 6.17(2)(a)(i) and (ii) of Rev. Proc. 2015-14. No other automatic method change in Rev. Proc. 2015-14 or in the Appendix of Rev. Proc. 2011-14 describes the change in method of accounting being made by the taxpayer in Scenarios 1-4.

SUMMARY

Scenario 1: The taxpayer is requesting to change the subsidiary's method to a permissible method of accounting and has to file a Form 3115 under the non-automatic method change procedures in Rev. Proc. 2015-13.

Scenario 2: The taxpayer is requesting to change the subsidiary's method to an impermissible method of accounting.

Scenario 3: The taxpayer is requesting to change the subsidiary's method to a permissible method of accounting provided the depreciation deduction for the final year

of the asset's recovery period that is allocable to exempt foreign trade income is not recovered until the subsidiary disposes of the asset. The taxpayer has to file a Form 3115 under the non-automatic method change procedures in Rev. Proc. 2015-13.

Scenario 4: The taxpayer is requesting to change to a permissible method of accounting provided the depreciation deduction for the final year of the asset's useful life (*i.e.*, for purposes of § 167(g), it is the 10th taxable year beginning after the taxable year in which the film was placed in service) that is allocable to excluded ETI is not recovered until the taxpayer disposes of the asset. The taxpayer has to file a Form 3115 under the non-automatic method change procedures in Rev. Proc. 2015-13.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

An examining agent must consider two key factors in determining whether any depreciation or amortization deductions allocable to exempt foreign trade income under former § 921(b) or allocable to excluded ETI under former § 114(c) may be recovered before the disposition of the asset. The first factor is whether the annual depreciation deductions are determined by using the unadjusted basis or adjusted basis of the asset. If the asset is depreciated under former § 168 (ACRS), we note that the annual depreciation deductions are determined by using the unadjusted basis of the asset, pursuant to former § 168(b)(1) and (f)(2), as applicable. The second factor is whether the recovery period or useful life of the asset expired before or after the end of the transaction(s) that qualified for FSC or ETI exclusion treatment, as applicable.

In addition, if the asset is depreciated under the income forecast method of § 167(g), the examining agent must take into account the application of § 167(g)(1)(C). Moreover, if the asset is depreciated under § 167 (and not under § 167(f) or (g), § 168, or former § 168), the examining agent must ascertain that the taxpayer has not depreciated the asset below its salvage value. *See* § 1.167(a)-1(a) and (c).

An examining agent also should determine, as a threshold matter, if all of the requirements of the FSC regime or the ETI exclusion provisions, as applicable, have been met, including that the transaction was properly characterized as a lease or license, rather than as a financing or a service that would not qualify for either FSC or ETI exclusion treatment. If the agent determines that the requirements were not met, then the depreciation analysis would change, and income adjustments may be appropriate.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-7005 if you have any further questions.

ATTACHMENT

EXAMPLES FOR THE FOUR SCENARIOS

Example 1 -- Scenario 1:

A calendar year taxpayer qualified as a FSC, placed a depreciable tangible asset with a basis of $1,000 in service on January 1, 1997, and leased it to an unrelated, non-U.S. entity pursuant to a 4-year lease entered into on January 1, 1997, and ended on December 31, 2000. Assume all requirements of the FSC regime have been met, including that this transaction was properly characterized as a lease. The taxpayer depreciated this asset under § 168(g) by using a recovery period of 5 years, the half-year convention, and the straight line method. Also assume that the taxable year 1997 is a taxable year of 12 full months, that the property remains in service through the end of 2002, that § 168(g)(3)(A) does not apply, and that the taxpayer did not use the optional depreciation tables pursuant to § 8 of Rev. Proc. 1987-57.

Year	Unrecovered Basis	Depreciation Rate	Yearly Depreciation	Taxable 70% *	Tax-exempt 30%	Unrecovered Basis Remaining in the Asset
1997	1,000.00	10.00%	100.00	70.00	30.00	930.00
1998	930.00	22.22%	206.65	144.66	61.99	785.34
1999	785.34	28.57%	224.37	157.06	67.31	628.28
2000	628.28	40.00%	251.31	175.92	75.39	452.36
2001**	452.36	66.67%	301.59	301.59	-	150.77
2002**	150.77	100.00%	150.77	150.77	-	0
				1,000.00		-

* The percentage changes from 70% to 100% when the FSC regime does not apply.

** The FSC regime does not apply because the lease had expired on December 31, 2000.

Example 2 -- Scenario 2:

The facts are the same as in Example 1, except that the taxpayer used the applicable optional depreciation table to determine the annual depreciation deductions of the asset pursuant to § 8 of Rev. Proc. 87-57.

Year	Unadjusted Basis	Depreciation Rate	Yearly Depreciation	Taxable 70% *	Tax-exempt 30%	Unrecovered Basis Remaining in the Asset
1997	1,000.00	10.00%	100.00	70.00	30.00	930.00
1998	1,000.00	20.00%	200.00	140.00	60.00	790.00
1999	1,000.00	20.00%	200.00	140.00	60.00	650.00
2000	1,000.00	20.00%	200.00	140.00	60.00	510.00
2001**	1,000.00	20.00%	200.00	200.00	-	310.00
2002**	1,000.00	10.00%	100.00	100.00	-	210.00
				790.00		210.00

* The percentage changes from 70% to 100% when the FSC regime does not apply.

** The FSC regime does not apply because the lease had expired on December 31, 2000.

Example 3 -- Scenario 3:

The facts are the same as Example 1, except that the lease ended on December 31, 2007. As a result, Asset A's recovery period ended prior to the expiration of the lease. Thus, the FSC regime applies for all years of Asset A's recovery period.

Year	Unrecovered Basis	Depreciation Rate	Yearly Depreciation	Taxable 70%	Tax-exempt 30%	Unrecovered Basis Remaining in the Asset
1997	1,000.00	10.00%	100.00	70.00	30.00	930.00
1998	930.00	22.22%	206.65	144.66	61.99	785.34
1999	785.34	28.57%	224.37	157.06	67.31	628.28
2000	628.28	40.00%	251.31	175.92	75.39	452.36
2001	452.36	66.67%	301.59	211.11	90.48	241.25
2002	241.25	100.00%	241.25	168.88	72.37	72.37
				927.63		72.37

Example 4 -- Scenario 4:

The taxpayer placed in service in 2003 a motion picture film and licensed it to an unrelated, non-U.S. entity pursuant to a 15-year license entered into on the film's placed-in-service date. Assume all requirements of the ETI exclusion provisions of former § 114 have been met, including that this transaction was properly characterized as a license. The taxpayer depreciated the film pursuant to the income forecast method in § 167(g). Assume that the yearly depreciation amount below is the amount of depreciation as determined under § 167(g). The taxpayer only deducted 70 percent of the film's total depreciation subject to the allocation required by former § 114. The 10th taxable year beginning after the taxable year in which the film was placed in service, as provided in § 167(g)(1)(C), ended prior to the expiration of the license. Thus, the ETI exclusion provisions apply to all of these taxable years.

Year	Unadjusted Basis	Yearly Depreciation	Taxable 70%	Tax-exempt 30%	Adjusted Basis Remaining in the Asset
2003	1,000.00	400.00	280.00	120.00	720.00
2004	1,000.00	400.00	280.00	120.00	440.00
2005	1,000.00	200.00	140.00	60.00	300.00
2006	1,000.00	150.00	105.00	45.00	195.00
2007	1,000.00	100.00	70.00	30.00	125.00
2008	1,000.00	50.00	35.00	15.00	90.00
2009	1,000.00	40.00	28.00	12.00	62.00
2010	1,000.00	30.00	21.00	9.00	41.00
2011	1,000.00	20.00	14.00	6.00	27.00
2012	1,000.00	20.00	14.00	6.00	13.00
2013	1,000.00	13.00	9.10	3.90	3.90
			996.10		3.90