

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:6-PLR-114503-99

Date:

Aug 17 2000

Re: Request for Private Letter Ruling

Legend

Taxpayer =

X =

Dear .

This letter responds to a request for a private letter ruling submitted on behalf of Taxpayer. The request concerns an election by Taxpayer under section 168(f)(1) of the Internal Revenue Code to use a method of depreciation not expressed in a term of years.

FACTS

Taxpayer is a subsidiary member of an affiliated group of corporations that files a consolidated federal income tax return. Taxpayer is primarily engaged in the business of leasing vehicles throughout the United States to corporate fleet users under operating lease arrangements. Many of the leases provide service arrangements whereby Taxpayer maintains the vehicles for the customer. The leases are for one year with automatic monthly renewals after the first year. While the actual number of months a vehicle is leased varies, the average lease lasts 32 months and the average mileage logged by a leased vehicle is 67,000 miles. If a vehicle is driven more miles than anticipated by Taxpayer when the lease was executed, the customer incurs additional cost. Upon termination of the lease vehicles are returned to Taxpayer and then sold by Taxpayer, usually at large vehicle auctions.

Taxpayer currently depreciates its leased vehicles under section 168 of the Code. Taxpayer would like to use a mileage-based depreciation method for its leased vehicles. Based on historical information maintained by Taxpayer, Taxpayer will determine the average mileage life of the leased vehicles (miles driven during the average lease term) and the average salvage value (in the context of this case, the resale value) of the leased vehicles at the end of the lease term. The average mileage

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life and salvage value will be reviewed annually and adjusted for any significant changes. Taxpayer will obtain odometer readings on all mileage-based depreciation vehicles at the end of each year. The current year's depreciation for these vehicles under the mileage-based depreciation method will then be determined by multiplying each vehicle's cost, less salvage value, by a fraction the numerator of which is the actual number of miles the vehicle was driven during the taxable year and the denominator of which is the average mileage life of the vehicle. The amount of depreciation claimed for a vehicle for the taxable year will depend upon the vehicle's mileage for the year. The vehicle will not be depreciated below its estimated salvage value.

Taxpayer leases a wide variety of vehicles. Taxpayer represents that the resale value of vehicles as a percentage of original cost is comparable for vehicles that cost up to \$23,500. Taxpayer also represents that the resale value of vehicles as a percentage of original cost is comparable for vehicles that cost between \$23,500 and \$35,000. Accordingly, Taxpayer will establish separate pools derived from these price ranges of vehicles to determine the average mileage lives and salvage values discussed in the preceding paragraph. Taxpayer's vehicles that cost in excess of \$35,000 (approximately 3% of Taxpayer's total fleet) will not be included in any pool where mileage-based depreciation is to be used.

Information submitted with Taxpayer's request indicates that the useful life of a leased vehicle depends in large part on the number of miles the vehicle is driven. In addition, Taxpayer's information indicates that the depreciation of its leased vehicles is not adequately measured by the time-based depreciation methods provided by section 168 of the Code.

LAW, ANALYSIS, and CONCLUSION

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

Section 168(a) of the Code provides that, except as otherwise provided in section 168, the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using the applicable depreciation method, recovery period, and convention.

Section 168(f)(1) of the Code provides that section 168 shall not apply to any property if the taxpayer elects to exclude the property from the application of section 168 and, for the first taxable year for which a depreciation deduction would be allowable with respect to the property in the hands of the taxpayer, the property is properly depreciated under the unit-of-production method or any method of depreciation not expressed in a term of years (other than the retirement-replacement-betterment

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method or similar method). Section 301.9100-7T(a) of the Income Tax Regulations provides that the election under section 168(f)(1) must be made for the taxable year in which the property is placed in service.

The provisions of section 167 of the Code and the regulations thereunder provide the applicable rules for calculating depreciation deductions on property not subject to section 168. In general, under section 167(a) a taxpayer is permitted a reasonable allowance for depreciation of property used in a trade or business or held for the production of income. Section 1.167(a)-1(a) of the regulations describes the allowance as the amount which should be set aside for the taxable year in accordance with a reasonably consistent plan, so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property. In addition, an asset may not be depreciated below a reasonable salvage value under any method of computing depreciation.

Section 1.167(a)-1(b) of the regulations provides that, for purposes of section 167 of the Code, the estimated useful life of an asset is the period over which the asset may reasonably be expected to be useful to the taxpayer in its trade or business or in the production of its income. This period shall be determined by reference to the taxpayer's experience with similar property taking into account present conditions and probable future developments. In addition, the estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in useful life is significant and there is a clear and convincing basis for redetermination.

Section 1.167(a)-1(c)(1) of the regulations defines "salvage value" as the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of income and is to be retired from service by the taxpayer. In addition, the regulation provides that salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation.

Prior to repeal by section 11812 of the Revenue Reconciliation Act of 1990 (the "1990 Act"), 1991-2 C.B. 484, 543, sections 167(b) and (c) of the Code described the methods of depreciation allowable under section 167. Section 11812 of the 1990 Act contains the depreciation deadwood provisions of H.R. 5822 as reported by the House Ways and Means Committee (H.R. Rep. No. 101-894). Conf. Rep. No. 964, 101st Cong., 2d Sess. 1141 (1990), 1991-2 C.B. 608. House Report No. 101-894 states that the amendments to the depreciation rules of Code section 167 are not intended to change in any respect the present-law rules relating to the allowable methods of

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depreciation. Thus, the provisions of former sections 167(b) and (c) continue to apply for determining the methods of depreciation allowable under section 167.

Former section 167(b) of the Code and section 1.167(b) of the regulations provide for the use of certain methods of computing depreciation under section 167. The methods enumerated are the straight line method, the declining balancing method, and the sum of the years digits method. Subject to the limitations provided in former section 167(c), these methods are deemed to produce a reasonable allowance for depreciation. In addition to the enumerated methods, former section 167(b) permits the use of other methods of depreciation which have been shown to be reasonable. Section 1.167(b) provides that any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167.

In Rev. Rul. 60-358, 1960-2 C.B. 68, the Internal Revenue Service noted that the time-based methods of depreciation described in former section 167(b) of the Code did not adequately measure the depreciation of television films and concluded that the income forecast method was an acceptable method of computing a reasonable allowance for depreciation of the films under section 167(a). In addition, the revenue ruling illustrates the application of the income forecast method. Under the income forecast method a fraction, the numerator of which is the income derived from the film for the taxable year and the denominator of which is the estimated total income to be derived from the film during its useful life, is multiplied by the cost of the film, after appropriate adjustment for estimated salvage value, to arrive at the amount of depreciation allowable for the taxable year.

Section 1.167(a)-8(d)(2) of the regulations provides that where a taxpayer has a large number of assets and depreciation is based on the average useful life of such assets, then, whether such assets are similar or dissimilar and regardless of whether they are accounted for in individual asset accounts or multiple asset accounts the allowance of losses on the normal retirement of such assets would distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before the expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, losses on normal retirements of such assets are not recognized.

A taxpayer must comply with the requirements of section 168(f)(1) of the Code before the taxpayer may depreciate any depreciable tangible property under a method of depreciation not expressed in a term of years. Specifically, the taxpayer must make a valid and proper election pursuant to section 168(f)(1)(A) for the first taxable year in which the property is placed in service. Further, the property must be property properly qualifying for depreciation under a method of depreciation not expressed in a term of years.

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In the present case, information submitted with Taxpayer's request indicates that the useful life of its leased vehicles is not adequately measured by the time-based depreciation methods provided by section 168 of the Code, but that the useful life of its leased vehicles depends in large part on the number of miles the vehicles are driven. Accordingly, based solely on Taxpayer's representations and the applicable law discussed above, we rule that Taxpayer's mileage-based depreciation method is an acceptable method of computing depreciation under sections 167(a) and 168(f)(1) of the Code for Taxpayer's leased vehicles with a cost of \$35,000 or less, subject to the following terms and conditions:

- 1) Taxpayer makes a timely election under section 168(f)(1) of the Code to exclude the vehicles subject to its mileage-based depreciation method from the provisions of section 168. See section 301.9100-7T(a) of the regulations for the time and manner of making this election;
- 2) In computing the annual allowance for depreciation under its mileage-based depreciation method, Taxpayer must take salvage value into account either by a reduction in the rate of depreciation or by a reduction in the amount subject to depreciation;
- 3) For the leased vehicles depreciated under its mileage-based depreciation method, Taxpayer may establish pools with respect to such vehicles where the resale value of the vehicles as a percentage of original cost is comparable. Based on Taxpayer's representations, if Taxpayer establishes pools for its leased vehicles, Taxpayer must establish at least two pools -- one pool for the vehicles that cost up to \$23,500 and another pool for the vehicles that cost between \$23,500 and \$35,000;
- 4) The recognition of gain or loss on the disposition of leased vehicles depreciated under Taxpayer's mileage-based depreciation method will be subject to the provisions of section 1.167(a)-8 of the regulations; and
- 5) The estimated total mileage a vehicle is expected to be useful to Taxpayer in its trade or business, the estimated remaining useful life of an automobile to Taxpayer, the total number of miles an automobile is driven each taxable year, and the estimated salvage value are questions of fact and are subject to examination by the district director.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of the transaction described above

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under any other provision of the Code. This ruling is directed only to the taxpayer on whose behalf it was requested. Section 6110(k)(3) provides that it may not be cited or used as precedent.

In accordance with the power of attorney, we are sending a copy of this letter ruling to your authorized representative. We also are sending a copy of the letter ruling to the District Director of the X District.

Sincerely yours,
Kathleen Reed
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes

cc: