Rethinking Depreciation of Antiques and Metals

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This article focuses on the change in the depreciation of tangible personal property caused by the enactment of section 168, and its impact on the depreciation of antiques and precious metals used in a trade or business. For taxpayers that have permanently capitalized business assets such as antiques and precious metals, there is an opportunity to file for an automatic change in accounting method and claim the benefit of lost depreciation deductions in the year of change.

The Demise of the Useful Life Requirement

One of the most important changes affecting depreciation of tangible property used in a trade or business involved the useful life requirement. In 1981 Congress passed the Economic Recovery Tax Act to increase productivity, promote growth, and stimulate capital formation.[1] Congress felt that rules on depreciation were too complex, inherently uncertain, and caused unproductive disagreements between taxpayers and the IRS.[2] This caused Congress to create the accelerated cost recovery system, which de-emphasized the useful life requirement and eliminated the salvage value limitation.[3]

For tax years after December 31, 1980, section 168[4] allows taxpayers depreciation deductions if the asset is tangible property; if the asset is used in a trade or business or held for the production of income; and if the asset is subject to exhaustion, wear and tear, or obsolescence. Notably, the element of useful life is missing from this list. (Note here that section 168 applies only to tangible assets.[5])

For tax years before January 1, 1981, taxpayers had to demonstrate that an asset met four general requirements before it could be depreciated under section 167: the asset had to be used in the trade or business or held for the production of income; the asset had to have basis; the asset had to have a determinable salvage value; and the asset had to have determinable useful life. (Note here that section 167 applies to both tangible and intangible assets.)

The following example highlights the importance of the changes caused by section 168 and the ACRS depreciation system.

Example 1: Depreciation of Antique Violin

> Mr. Liddle is a professional violinist. In 1987 he paid $28,000 for a famous Ruggeri bass violin that he purchased at an auction. The instrument was in excellent working condition and had no cracks or damage despite being over 300 years old. Mr. Liddle used the Ruggeri violin as his primary instrument during all of his performances and even practiced with it up to 7½ hours each day. The expected life of the violin with the proper maintenance was 30 to 40 years. The excessive wear and tear damaged the violin and caused Mr. Liddle to repair the instrument on a regular basis. This famous violin continues to appreciate in value as a collectible despite its wear and tear.
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> Can Mr. Liddle depreciate the famous Ruggeri violin?

Clearly, under the rules that existed before 1981, section 167 would disallow depreciation for the Ruggeri violin because the salvage value would exceed the cost basis and the useful life would be difficult to determine. However, under section 168, depreciation is allowed because the three tests are clearly satisfied. The Ruggeri violin is tangible property, used in a business, and subject to wear and tear.

Example 1 illustrates the facts in *Liddle*.[6] The IRS disallowed the depreciation claimed by the Liddles because the taxpayers could not demonstrate that the

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[1]P.L. 97-34, 95 Stat. 203.

[2]*Id.*

[3]*See Liddle v. Commissioner*, 65 F.3d 329 (3d Cir. 1995), *Doc 95-8528*, *95 TNT 179-9*.

[4]The modified accelerated cost recovery system applies for years after December 31, 1986. The MACRS regime uses the same fundamental principles as the ACRS regime (section 168) when determining whether tangible property is depreciable.

[5]The recovery of intangible assets was addressed by the enactment of section 197 in 1993.

[6]*See also Simon v. Commissioner*, 68 F.3d 41 (2d Cir. 1995), *Doc 95-9795*, *95 TNT 209-15*, *nonacq.* 1996-2 C.B. 2; *Selig v. Commissioner*, 70 T.C.M. 1125 (1995), *Doc 95-9995*, *95 TNT 214-13*; and *Hospital Corporation of America & Subs. v. Commissioner*, 109 T.C. 21 (1997), *Doc 97-21666*, *97 TNT 143-6* (the Tax Court, in both cases, rejected the ''useful life'' test post-Economic Recovery Tax Act and adopted the exhaustion, wear and tear, or obsolescence

(Footnote continued on next page.)

property has a ''determinable useful life.'' The IRS argued that ''de-emphasis of useful life is not synonymous with abrogation of useful life.'' However, the court held that Congress de-emphasized useful life by ''creating four short periods of time over which taxpayers can depreciate tangible personalty used in their trade or business.'' The Third Circuit affirmed the Tax Court's decision and allowed the taxpayers to deduct depreciation.[7]

Although the IRS has not acquiesced to the *Liddle* and *Simon* decisions, in TAM 199927001,[8] the IRS addressed whether a taxpayer was entitled to deduct expenses as research and experimental expenditures under section 174. For expenses to be deductible under section 174, the property for which the expenses were incurred must not be depreciable property in the hands of the taxpayer.[9] In determining whether the property at issue was depreciable, the IRS stated:

> In fact, the plain meaning of the term ''property of a character subject to the allowance for depreciation'' refers to the character of the property, and not to whether it is depreciable in the hands of a particular taxpayer. The term has been widely construed to *impose only three requirements: (1) that the property is subject to exhaustion, wear and tear or obsolescence; (2) that the property be used over a period of years; and (3) that the property be used in a trade or business or held for the production of income.* See section 167(a). [Citing both *Liddle* and *Simon*] [Emphasis added.]

Example 2: Depreciation of Metals

> Blue Steel Inc. is a glass manufacturer and uses molten tin in its float process when making glass. The float process involves melting limestone, sand, soda ash, and other glass material components to form liquefied molten glass. The molten glass then proceeds into a ''tin bath'' structure that holds up to 200 tons of liquefied, molten tin. Once the glass is hardened, it is then cut into various sizes. The molten tin is an integral part of the manufacturing process. During this process some of the tin oxidizes and has to be physically removed and new tin must be added to the tin bath.
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> Can Blue Steel depreciate the 200-ton base amount of molten tin?

In Rev. Rul. 75-491[10] the IRS ruled that the base amount of tin is not depreciable because it does not lose its identity as tin or become part of a depreciable asset. The IRS also ruled that the tin added to keep the base amount at the optimal level is a deduction under section 162 as part of the direct costs of producing the glass (that is, it is a cost of the inventory).

However, in *O'Shaughnessy*, the taxpayer depreciated the base amount of tin and also deducted the cost of the new tin added to the tin bath as a repair and maintenance expense. The IRS allowed the repair and maintenance expense deduction, but disallowed the depreciation claimed on the base amount of tin, relying on Rev. Rul. 75-491. The Eighth Circuit affirmed the district court decision that depreciation deductions are allowed because the tin is subject to ''exhaustion, wear and tear'' within the meaning of section 168. The Eighth Circuit also ruled that Rev. Rul. 75-491 was not controlling because it ''predates the substantial restructuring of the depreciation rules effected by the adoption of the Accelerated Cost Recovery System (ACRS) (1981) and the Modified Accelerated Cost Recovery System (MACRS) (1986).''

Because the courts have embraced the demise of the useful life requirement and have instead focused on whether an asset is subject to ''exhaustion, wear and tear,'' taxpayers should revisit the basis of their assets and rethink how they are applying the tax depreciation rules — it can yield significant benefits. If taxpayers have incorrectly applied the section 168 depreciation rules to tangible assets or the section 167 rules to intangible assets, an automatic method change can be obtained.[11] This change generally results in a favorable adjustment that can be used in one year. Other revenue rulings that may be affected by the *O'Shaughnessy* decision include Rev. Rul. 68-192[12] (regarding radium used as a therapeutic agent) and Rev. Rul. 90-65[13] (regarding precious metals such as gold and platinum used in a trade or business).

Changing a Method of Accounting

In General

In determining whether a taxpayer can change its method of accounting for some types of depreciable property, it is first necessary to determine whether the taxpayer has established a method of accounting for those costs. Once that has been determined, it is then necessary to determine whether the taxpayer can change its method of accounting to depreciate or amortize the costs. If a change may be made, the mechanics of the change, including any section 481 adjustment, must be determined.

Until recently, neither the code nor the regulations specifically defined a ''method of accounting.'' Reg. section 1.446-1(a)(2) provides that an accounting method must: be permissible and clearly reflect income, be used consistently, and be continuously employed, unless the

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test); *O'Shaughnessy v. Commissioner*, 89 A.F.T.R. 2d 2002-658 (D. Minn. 2001), *aff'd*, 332 F.3d 1125 (8th Cir. 2003), *Doc 2003-14490, 2003 TNT 115-4* (the U.S. district court held that because molten tin used in glass manufacturing suffers volumetric losses, it is subject to ''exhaustion wear and tear'' and is therefore depreciable under section 168).

[7]It is important to highlight that ''passive assets'' such as artwork placed on office walls generally do not qualify for depreciation because of the difficulty of showing a connection between the decorations and an increase in business income. *Simon v. Commissioner*; *Liddle v. Commissioner*.

[8]*Doc 1999-23211*, *1999 TNT 132-24*.

[9]Section 174(c).

[10]1975-2 C.B. 19.

[11]Section 446(e). *See* Rev. Proc. 2002-9, 2002-1 C.B. 327, *Doc 2002-555, 2002 TNT 5-9*; Form 3115.

[12]1968-1 C.B. 78.

[13]1990-2 C.B. 41.

taxpayer receives consent from the commissioner to change the method of accounting.

Rev. Rul. 90-38[14] states that if a taxpayer treats an item properly in the first return that reflects the item, it is not necessary to treat the item consistently in two or more consecutive tax returns before it has adopted a method of accounting. In other words, by treating an item correctly in one return, the taxpayer has established a method of accounting. Also, Rev. Rul. 90-38 provides a two-year rule for taxpayers that use an impermissible method of accounting for depreciation. If a taxpayer incorrectly accounts for the depreciation of an asset for two or more consecutively filed federal income tax returns, that method is considered adopted by the taxpayer. To change the incorrect method, the taxpayer would have to obtain permission from the IRS.

However, in Rev. Proc. 2004-11,[15] notwithstanding the two-year rule in Rev. Rul. 90-38, a taxpayer may file a Form 3115, ''Application for Change in Accounting Method,'' under Rev. Proc. 97-27, 1997-1 C.B. 680 (or its successor), or Rev. Proc. 2002-9,[16] as applicable, to change from an impermissible method of accounting for depreciation to a permissible method of accounting for depreciation under reg. section 1.446-1(e)(2)(ii)(d) for any depreciable or amortizable property subject to reg. section 1.446-1(e)(2)(ii)(d).

Alternatively, the taxpayer may make the change from the impermissible depreciation method to the permissible depreciation method by filing an amended federal tax return if the impermissible method was only used in one year.

In summary, the IRS allows taxpayers to change their impermissible method of accounting for depreciable property by filing a Form 3115 (whether or not the incorrect method is used for one or more years) and also allows taxpayers to correct an impermissible method of accounting for depreciable property by filing an amended return if the incorrect method was only used in one year. (Note that Rev. Proc. 2004-11 was clarified, modified, amplified, and superseded by Rev. Proc. 2007-16.[17] The changes between the two procedures were largely administrative in nature, with little affect on the technical merits of Rev. Proc. 2004-11.)

Changes Related to Depreciation and Amortization

The IRS has issued final regulations under section 446(e) on whether a change in computing depreciation or amortization, as well as a change in the treatment of an asset from nondepreciable or nonamortizable to a depreciable or amortizable asset, is a change in method of accounting.[18]

Reg. section 1.446-1(e)(2)(ii)(a) provides that a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in the overall plan. In most cases, a method is not established without consistent treatment of a material item. 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.

Reg. 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 computation of tax liability (for example, errors in computing foreign tax credits, net operating losses). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of that item into income or the taking of a deduction (for example, reclassification of an interest expense to dividends paid). An adjustment to increase a bad debt reserve and a change in the treatment of an item that results from a change in facts are also not changes in accounting method.

Reg. section 1.1016-3(h) clarifies that the ''allowed or allowable'' rule (for depreciable and amortizable assets) in section 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation or amortization is a change in method of accounting under section 446(e).

Reg. section 1.446-1(e)(2)(ii)(d)(2) provides a list of depreciation and amortization changes that qualify as changes in method of accounting:

- changes in the depreciation method, period of recovery, or convention of a depreciable or amortizable asset;
- changes to or from claiming the section 168(k) or section 1400L(b) additional first-year depreciation deduction, under some circumstances;
- changing the salvage value of an asset to zero, if the salvage value of the asset is expressly treated as zero under the code (any other change in salvage value is not treated as a change in method of accounting);
- changes in accounting for depreciable or amortizable assets from single asset accounting to multiple asset accounting (pooling), or vice versa, or from one type of multiple asset accounting (pooling) to a different type of multiple asset accounting (pooling);
- for mass assets accounted for in multiple asset accounts or pools, changes in the method of identifying which assets have been disposed (for example, from specific identification to a first-in, first-out method);
- changes in the treatment of an asset from nondepreciable to depreciable (for example, a change in the treatment of an asset that was used entirely in the taxpayer's trade or business and was never held for sale from being treated as inventory to being treated as depreciable property).

Reg. section 1.446-1(e)(2)(ii)(d)(3) provides that the following are not changes in method of accounting:

- an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168);

[14]1990-1 C.B. 57.

[15]2004-1 C.B. 311, *Doc 2003-27240, 2003 TNT 250-4*.

[16]Also, Rev. Proc. 2004-11 revised the depreciation changes in Rev. Proc. 2002-9, to conform to these regulations.

[17]2007-1 C.B. 358, *Doc 2006-25669, 2006 TNT 248-9*.

[18]T.D. 9307, *Doc 2006-25620, 2006 TNT 247-6*.

- a change in computing depreciation allowances in the tax year in which the use of property changes in the hands of the same taxpayer;
- making a late depreciation election or revoking a timely valid depreciation election (or making a late election or revoking a timely valid election under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993[19] regarding amortizable section 197 intangibles); and
- a change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting.

In the context of antiques and metals, taxpayers that have not depreciated these assets have adopted an impermissible method of accounting (that is, permanent capitalization) for those costs. Accordingly, under reg. section 1.446-1(e)(2)(ii)(d)(2) taxpayers are authorized to change to a permissible method under section 446(e). Taxpayers must request approval by completing and filing Form 3115 with the IRS National Office.[20]

Importantly, the IRS has provided a mechanism for *automatic grants* of some changes of accounting method in Rev. Proc. 2002-9.[21] All other method change requests (that is, manual changes) should be made in accordance with the procedures outlined in Rev. Proc. 97-27.

Rev. Proc. 2002-9 provides the procedures by which a taxpayer may obtain automatic consent to change its method of accounting. In general, Rev. Proc. 2002-9 is effective for method changes implemented in tax years ending on or after December 31, 2001.[22] Rev. Proc. 2002-9 provides that a taxpayer that complies with all of the revenue procedure's applicable provisions will have automatically obtained the consent of the commissioner to change its method of accounting under section 446(e). The appendix to Rev. Proc. 2002-9 provides which methods of accounting are afforded the automatic change.

For depreciation or amortization, section 2.01(1)(a) of the appendix[23] (as modified by Rev. Proc. 2004-11 and Rev. Proc. 2007-16) provides that a taxpayer who wants to change from an impermissible method of accounting for depreciation or amortization (that is, did not claim any depreciation or amortization) to a permissible method of accounting under which the taxpayer will claim depreciation or amortization, is a change in accounting method that requires the consent of the commissioner. Section 2.01(1)(a) of the appendix provides that an automatic change will be granted in the case of a taxpayer that meets several requirements. The requirements are as follows: (1) the taxpayer has used an impermissible method of accounting for depreciation in at least the two tax years immediately preceding the year of change; (2) the taxpayer is making a change under reg. section 1.446-1(e)(2)(ii)(d); (3) the property would be depreciable under section 56(a)(1), 56(g)(4)(A), 167, 168, 197, 1400I, 1400L(b), 1400L(c), or 168 (before its amendment in 1986); and (4) the property is owned by the taxpayer at the beginning of the year of change.[24]

Appendix section 2.01(1)(b) outlines the requirements of a change in method of accounting when a taxpayer has an impermissible method of accounting for depreciation under which the taxpayer did not claim the depreciation allowable to a permissible method under which the taxpayer will claim the depreciation allowable. Even if the taxpayer does not satisfy appendix section 2.01(1)(a) because the item of property is placed in service by the taxpayer in the tax year immediately preceding the year of change, the taxpayer can still qualify for an automatic change from the impermissible depreciation method to the permissible depreciation method for the property by filing a Form 3115 under Rev. Proc. 2007-16. Alternatively, the taxpayer may change from the impermissible depreciation method to the permissible method for the property by filing an amended federal tax return for the property's placed-in-service year before the date the taxpayer files its federal tax return for the tax year succeeding the placed-in-service year.

Appendix section 2.01(2) contains an additional requirement that a taxpayer must demonstrate that it is changing to a permissible method of accounting for depreciation or amortization for the item of property. That permissible method is the same method that determines the depreciation allowable for the item of property. Appendix section 2.01(5) provides that the amount of depreciation allowable is the amount determined under section 56(a)(1), 56(g)(4)(A), 167, 168, 197, 1400I, 1400L(b), 1400L(c), or 168 (before its amendment in 1986).

Once it has been determined that the taxpayer is entitled to the automatic consent to change from an impermissible method of accounting to a permissible method of accounting, section 4.04(1)(c) of Rev. Proc. 2002-19[25] provides that a favorable section 481 adjustment (that is, reduces taxable income) is taken into income over a one-year period beginning with the year of change.

As a result, taxpayers that have assets that are not being depreciated should consider applying for an automatic method change by filing Form 3115. Please note that this article was written before the release of Rev. Proc. 2008-52, IRB 2008-36, *Doc 2008-17948, 2008 TNT 161-5*, which updates and supersedes the automatic change procedures described in Rev. Proc. 2002-9. The updates in Rev. Proc. 2008-52 as they relate to depreciation are largely administrativge and do not impact the analysis above.

[19] 107 Stat. 312, 540.

[20] If the asset is treated incorrectly on only one tax return, taxpayers can either file a Form 3115 or file an amended return to correct the treatment. Rev. Proc. 2007-16.

[21] *Supra* note 17.

[22] Section 13.01 of Rev. Proc 2002-9.

[23] For changes in depreciation that involve a change from one permissible method to another, see section 2.02 of the revised appendix in Rev. Proc. 2002-9.

[24] Section 2.01(1)(c) of the appendix provides that the automatic change will not apply even though the requirements of section 2.01(1)(a) are satisfied in 14 situations. None of the 14 situations are applicable to a change from capitalizing costs to depreciating costs under section 167, 168, or 197.

[25] 2002-1 C.B. 696, *Doc 2002-6514, 2002 TNT 51-9*.