

to recharacterize a lease as a conditional sale or otherwise for federal income tax purposes. Unless otherwise indicated, parties to the transactions are not related to one another.

Example. Financial obligation with respect to an additional period—(i) *Facts.* X, a taxable corporation, and Y, a foreign airline whose income is not subject to United States taxation, enter into a lease agreement under which X agrees to lease an aircraft to Y for a period of 10 years. The lease agreement provides that, at the end of the lease period, Y is obligated to find a subsequent lessee (replacement lessee) to enter into a subsequent lease (replacement lease) of the aircraft from X for an additional 10-year period. The provisions of the lease agreement require that any replacement lessee be unrelated to Y and that it not be a tax-exempt entity as defined in section 168(h)(2). The provisions of the lease agreement also set forth the basic terms and conditions of the replacement lease, including its duration and the required rental payments. In the event Y fails to secure a replacement lease, the lease agreement requires Y to make a payment to X in an amount determined under the lease agreement.

(ii) *Application of this section.* The lease agreement between X and Y obligates Y to make a payment in the event the aircraft is not leased for the period commencing after the initial 10-year lease period and ending on the date the replacement lease is scheduled to end. Accordingly, pursuant to paragraph (b) of this section, the term of the lease between X and Y includes such additional period, and the lease term is 20 years for purposes of section 168.

(iii) *Facts modified.* Assume the same facts as in paragraph (i) of this *Example*, except that Y is required to guarantee the payment of rentals under the 10-year replacement lease and to make a payment to X equal to the present value of any excess of the replacement lease rental payments specified in the lease agreement between X and Y, over the rental payments actually agreed to be paid by the replacement lessee. Pursuant to paragraph (b) of this section, the term of the lease between X and Y includes the additional period, and the lease term is 20 years for purposes of section 168.

(iv) *Changes in status.* If, upon the conclusion of the stated duration of the lease between X and Y, the aircraft either is returned to X or leased to a replacement lessee that is not a tax-exempt entity as defined in section 168(h)(2), the subsequent method of depreciation will be determined pursuant to section 168(i)(5).

(g) *Effective date*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, this section applies to

leases entered into on or after April 20, 1995.

(2) *Special rules.* Paragraphs (b)(1)(ii) and (c) of this section apply to leases entered into after April 26, 1996.

[T.D. 8667, 61 FR 18677, Apr. 29, 1996]

§ 1.168(i)-3 Treatment of excess deferred income tax reserve upon disposition of deregulated public utility property.

(a) *Scope*—(1) *In general.* This section provides rules for the application of section 203(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2146) to a taxpayer with respect to public utility property (within the meaning of section 168(i)(10)) that ceases, whether by disposition, deregulation, or otherwise, to be public utility property with respect to the taxpayer and that is not described in paragraph (a)(2) of this section (deregulated public utility property).

(2) *Exceptions.* This section does not apply to the following property:

(i) Property that ceases to be public utility property with respect to the taxpayer on account of an ordinary retirement within the meaning of § 1.167(a)-11(d)(3)(ii).

(ii) Property transferred by the taxpayer if after the transfer the property is public utility property of the transferee and the taxpayer's excess tax reserve with respect to the property (within the meaning of section 203(e) of the Tax Reform Act of 1986) is treated as an excess tax reserve of the transferee with respect to the property.

(b) *Amount of reduction.* If public utility property of a taxpayer becomes deregulated public utility property to which this section applies, the reduction in the taxpayer's excess tax reserve permitted under section 203(e) of the Tax Reform Act of 1986 is equal to the amount by which the reserve could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued use of its normalization method of accounting with respect to such property.

(c) *Cross reference.* See § 1.46-6(k) for rules relating to the treatment of accumulated deferred investment tax credits when utilities dispose of regulated public utility property.

(d) *Effective/applicability dates*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, this section applies to public utility property that becomes deregulated public utility property after December 21, 2005.

(2) *Property that becomes public utility property of the transferee.* This section does not apply to property that becomes deregulated public utility property with respect to a taxpayer on account of a transfer on or before March 20, 2008 if after the transfer the property is public utility property of the transferee.

(3) *Application of regulation project (REG-104385-01).* A reduction in the taxpayer's excess deferred income tax reserve will be treated as ratable if it is consistent with the proposed rules in regulation project (REG-104385-01) (68 FR 10190) March 4, 2003, and occurs during the period beginning on March 5, 2003, and ending on the earlier of—

(i) The last date on which the utility's rates are determined under the rate order in effect on December 21, 2005; or

(ii) December 21, 2007.

[T.D. 9387, 73 FR 14937, Mar. 20, 2008]

§ 1.168(i)-4 Changes in use.

(a) *Scope.* This section provides the rules for determining the depreciation allowance for MACRS property (as defined in § 1.168(b)-1T(a)(2)) for which the use changes in the hands of the same taxpayer (change in the use). The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a) for the year of change and any subsequent taxable year. For purposes of this section, the year of change is the taxable year in which a change in the use occurs.

(b) *Conversion to business or income-producing use*—(1) *Depreciation deduction allowable.* This paragraph (b) applies to property that is converted from personal use to use in a taxpayer's trade or business, or for the production of income, during a taxable year. This conversion includes property that was previously used by the taxpayer for personal purposes, including real property (other than land) that is acquired before 1987 and converted from personal use to business or in-

come-producing use after 1986, and depreciable property that was previously used by a tax-exempt entity before the entity changed to a taxable entity. Except as otherwise provided by the Internal Revenue Code or regulations under the Internal Revenue Code, upon a conversion to business or income-producing use, the depreciation allowance for the year of change and any subsequent taxable year is determined as though the property is placed in service by the taxpayer on the date on which the conversion occurs. Thus, except as otherwise provided by the Internal Revenue Code or regulations under the Internal Revenue Code, the taxpayer must use any applicable depreciation method, recovery period, and convention prescribed under section 168 for the property in the year of change, consistent with any election made under section 168 by the taxpayer for that year (see, for example, section 168(b)(5)). See §§ 1.168(k)-1T(f)(6)(iii) and 1.1400L(b)-1T(f)(6) for the additional first year depreciation deduction rules applicable to a conversion to business or income-producing use. The depreciable basis of the property for the year of change is the lesser of its fair market value or its adjusted depreciable basis (as defined in § 1.168(b)-1T(a)(4)), as applicable, at the time of the conversion to business or income-producing use.

(2) *Example.* The application of this paragraph (b) is illustrated by the following example:

Example. A, a calendar-year taxpayer, purchases a house in 1985 that she occupies as her principal residence. In February 2004, A ceases to occupy the house and converts it to residential rental property. At the time of the conversion to residential rental property, the house's fair market value (excluding land) is \$130,000 and adjusted depreciable basis attributable to the house (excluding land) is \$150,000. Pursuant to this paragraph (b), A is considered to have placed in service residential rental property in February 2004 with a depreciable basis of \$130,000. A depreciates the residential rental property under the general depreciation system by using the straight-line method, a 27.5-year recovery period, and the mid-month convention. Pursuant to §§ 1.168(k)-1T(f)(6)(iii)(B) or 1.1400L(b)-1T(f)(6), this property is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). Thus, the depreciation allowance