



Section of Taxation

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@abanet.org

August 23, 2010

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Deduction and Capitalization of Expenditures Related to Tangible Property

Dear Commissioner Shulman:

Enclosed are comments in response to Notice of Proposed Rulemaking (REG-168745-03), proposing Regulations under section 263(a) relating to the deduction and capitalization of expenditures related to tangible property. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Charles H. Egerton
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Clarissa Potter, Deputy Chief Counsel (Technical), Internal Revenue Service
George Blaine, Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Jeffrey Van Hove, Acting Tax Legislative Counsel, Department of the Treasury
Brandon Carlton, Attorney-Advisor, Department of the Treasury
Eric Lucas, Attorney-Advisor, Department of the Treasury
Andrew Keyso, Deputy Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Scott Dinwiddie, Special Counsel to the Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Merrill Feldstein, Senior Counsel, Office of Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Kimberly Koch, Senior Technician Reviewer, Office of Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service

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ABA SECTION OF TAXATION
COMMENTS ON DEDUCTION AND CAPITALIZATION OF
EXPENDITURES RELATED TO TANGIBLE PROPERTY

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Ellen McElroy of the Capital Recovery and Leasing Committee of the Section of Taxation. Substantive contributions were made by David Jacobson. The Comments were reviewed by Carol Conjura, Last Retiring Chair of the Committee on Tax Accounting. The comments were further reviewed by Kenneth Kempson of the Section’s Committee on Government Submissions and by Kevin D. Anderson, Council Director, for the Capital Recovery and Leasing Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Ellen McElroy
Phone: (202) 220-1589
Email: mcelroye@pepperlaw.com

Dated: August 23, 2010

Executive Summary

These Comments are prepared in response to the Notice of Proposed Rulemaking (REG-168745-03) published in the Federal Register on March 10, 2008 (the “Proposed Regulations”).¹ The Proposed Regulations prescribe rules and standards regarding the application of section 263(a)² to amounts paid to acquire, produce, or improve tangible property. As a general rule, the Proposed Regulations confirm that a taxpayer must capitalize the costs of acquiring or producing tangible property as well as certain costs that facilitate the acquisition. A taxpayer that incurs costs to repair an asset after it has been placed in service must determine the relevant unit of property and then allocate costs to the extent that the expenditures result in an improvement to that unit of property. The Proposed Regulations provide, *inter alia*, a de minimis rule and special rules for rotatable spare parts and for expenditures following casualty losses. The Proposed Regulations modify earlier Proposed Regulations³ issued in 2006 regarding section 263(a) (the “2006 Proposed Regulations”).

We believe application of the principles included in the Proposed Regulations would result in greater taxpayer compliance and a more efficient and fairer tax system. The principal goal of these Comments is to identify additional issues that it would be useful to address in the final Regulations and to suggest refinements intended to better achieve the goals of the Proposed Regulations.

Our Comments are summarized as follows:

A. Expansion of the Special Exception for Transaction Costs to All Property Acquisitions

We commend the Internal Revenue Service (the “Service”) and the Treasury Department (“Treasury”) for including a special rule that allows taxpayers to deduct costs incurred to investigate whether to acquire real property and which real property to acquire. We recommend that the final Regulations expand this exception to the acquisition of all property, both real and personal. Unless this rule is expanded, tangible personal property would be the only property for which pre-decisional investigatory costs are required to be capitalized in an acquisition context. We believe that the reasons for this rule with respect to real property apply equally to personal property. The Preamble indicates that the exclusion was added so that taxpayers would not be required to undertake complicated allocations of costs. Because taxpayers would still be required to capitalize costs to personal property, complicated allocations of investigatory costs would continue to be required with acquisitions involving both real and personal property and in acquisitions of various personal properties. For these

¹ Prop. Reg. §§ 1.263(a)-1 through 1.263(a)-3, 73 Fed. Reg. 12,838 (2008).

² References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

³ Prop. Reg. §§ 1.263(a)-1 through 1.263(a)-3, 71 Fed. Reg. 48,589 (2006).

reasons, we suggest that the final Regulations expand the scope of this exclusion so that it applies to acquisitions of all tangible property.

B. De Minimis Rule for Acquisitions

The 2006 Proposed Regulations did not include a specific de minimis rule for the acquisition or production of property, and we applaud the Service and Treasury for including a de minimis rule in the Proposed Regulations. The stated goal of the new de minimis rule is “to reduce burden and provide simplification.”⁴ To the same end, we recommend that the rule as presented in the Proposed Regulations be revised by explicitly eliminating the annual distortion test for taxpayers with an applicable financial statement (“AFS”)⁵ that is prepared in accordance with generally accepted accounting principles (“GAAP”), International Financial Reporting Standards (“IFRS”), or other mandated accounting standards (such as regulatory accounting standards). We further suggest that the final Regulations contain a separate de minimis rule for taxpayers without an AFS.

We also recommend that the Preamble to the final Regulations make explicit that taxpayers may choose to continue to use de minimis amounts pursuant to agreements reached between examining agents and taxpayers, as is made clear by the Preamble to the Proposed Regulations. In addition, we request that the final Regulations specify whether a change in method of accounting occurs based on a change in the treatment of de minimis amounts as a result of a change in the de minimis amount for financial accounting purposes (*e.g.*, when there is a change in the de minimis amount on an AFS). We do not believe that it is a change in method of accounting when there is a change in the de minimis threshold in the AFS. If it is determined that this change is a change in accounting method, however, we recommend that taxpayers be permitted to make the change automatically and on a cut-off basis (*i.e.*, without any section 481(a) adjustment).

C. Treatment of Replacement Parts and Interaction with Materials and Supplies under Regulation section 1.162-3

We commend the Service and Treasury for providing specific guidance with respect to the treatment of materials and supplies in the Proposed Regulations. Although we appreciate this clarification, we fear that these rules may create an inconsistency in the treatment of

⁴ Preamble to Prop. Reg. §§ 1.263(a)-1 through 1.263(a)-3, 73 Fed. Reg. 12,838, 12,840-41 (2008) (the “Preamble”).

⁵ Preamble at 12,841. Section 4.06 of Revenue Procedure 2004-34 defines “applicable financial statements” in descending priority as (i) a financial statement required to be filed with the Securities and Exchange Commission (“SEC”) (the 10-K or the Annual Statement to Shareholders); (ii) a certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign corporation, by the report of a similarly qualified independent professional), that is used for credit purposes, reporting to shareholders, or any other substantial non-tax purpose; or (iii) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agencies (other than the SEC or the Service).

similar items under the various rules that control when materials and supplies and other replacement parts become deductible. A taxpayer may potentially be subject to four separate timing rules with respect to items otherwise considered as materials and supplies. These varied rules necessitate complex record keeping. To eliminate this complexity, we recommend that the final Regulations provide that a taxpayer electing to use the de minimis exception is entitled to apply the de minimis exception to all property qualifying as de minimis, including property costing \$100 or less that would otherwise be treated as materials and supplies.

D. Treatment of Rotable Spare Parts

We believe the Proposed Regulations' treatment of rotatable spare parts reflects a significant departure from current law. We also believe the proposed treatment would add administrative complexity, in that a taxpayer would be required to maintain records regarding when rotatable spare parts are taken out of service to identify the appropriate time for a deduction. Moreover, we believe that the proposed rule would not accurately reflect the economic reality of parts use. By delaying a deduction until the time the rotatable is disposed of, the cost recovery for these items would no longer be well matched against the income they generate.

We recommend that the Regulations, when finalized, eliminate the rule that rotatable spare parts may not be deducted until the taxpayer disposes of the parts. To the extent that the proposed treatment of rotatable parts is preserved, we recommend that the final Regulations permit taxpayers to elect to continue to use the method prescribed under Rev. Rul. 69-370⁶ to account for rotatable parts, or any other methods that the Service allows that may be more economically accurate.

E. Use of Financial Reporting Life in the Routine Maintenance Safe Harbor

The Proposed Regulations provide a safe harbor under which the costs of routine maintenance may be deducted if the expenses occur more than once during the class life of the asset. We welcome the addition of this safe harbor. We suggest, however, that the final Regulations also permit taxpayers to use the property's life determined under GAAP, IFRS, or other mandated accounting standards (such as regulatory accounting standards) to ensure that the standard more accurately reflects a taxpayer's underlying economic facts and circumstances.

F. The Special Casualty Loss Rule

The Proposed Regulations provide that if a basis adjustment has been made as a result of either a casualty loss deduction or receipt of insurance proceeds for a casualty event, subsequent repair expenses on that property must be capitalized. The Proposed Regulations otherwise provide a uniform and consistent approach for determining whether a cost is

⁶ 1969-2 C.B. 34.

properly treated as a deductible repair expense based on the effect of the cost on the unit of property. Solely in the case of casualty losses, however, the cause of the expense is the exclusive determinant of deductibility, without regard to the effect on the unit of property.

This approach appears to be based on the reasoning that, because casualty losses are extraordinary events, the response to them cannot be “ordinary” as required for deduction under section 162. We believe this conclusion is contrary to the conclusion of the Supreme Court that “once in a lifetime” events may be ordinary for purposes of section 162.⁷

We recommend that the final Regulations eliminate the special rule for expenditures following a casualty loss, thus providing a uniform and consistent approach to evaluating costs. If this recommendation is not adopted, we suggest in the alternative that the final Regulations permit taxpayers to forgo the casualty loss and claim appropriate repair deductions under the general rules of the Regulations.

G. Transition Rules and Accounting Method Changes

The Preamble notes that a change in the treatment of repair costs is a change in method of accounting, and requests comments regarding how to implement such accounting method changes. The Proposed Regulations provide that the rules are applicable to amounts paid or incurred in taxable years beginning on or after the date the final Regulations are issued. We suggest that taxpayers be permitted to file early applications to change their method of accounting during the interim between issuance of the final Regulations and the subsequent taxable year.

The Proposed Regulations are interpretive Regulations generally intended to clarify rather than change current law. Except with respect to any de minimis rules or safe harbor guidance, we suggest that the Regulations, when finalized, provide that taxpayers may rely on the principles of the final Regulations in taxable years prior to their effective date.

We also suggest that automatic consent be provided for taxpayers to change a method of accounting to comply with the final Regulations. Consistent with the approach used in the final “intangibles” Regulations, we also recommend that the scope limitations of Rev. Proc. 2008-52⁸ be waived for the first taxable year following the issuance of the final Regulations.⁹ Further, we suggest that audit protection be provided generally for these accounting method

⁷ *Helvering v. Welch*, 290 U.S. 111, 112 (1933).

⁸ 2008-2 C.B. 587, as amplified, clarified, and modified by Rev. Proc. 2009-39, 2009-38 I.R.B. 371, as corrected by Announcement 2009-67, 2009-38 I.R.B. 388.

⁹ See, e.g., Reg. § 1.263(a)-4(p)(2), which provides that “[a]ny limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting to comply with this section for its first taxable year ending on or after December 31, 2003.”

changes if the Service has not challenged the treatment of the taxpayer's repair costs prior to the filing of the Form 3115, Application for Change in Accounting Method.

We recommend that accounting method changes made to comply with the final Regulations be made with a section 481(a) adjustment.¹⁰ We believe this is appropriate because, unlike the recently issued Regulation sections 1.263(a)-4 and 1.263(a)-5 relating to intangible assets and transaction costs, these changes would relate to currently held depreciable assets for which records likely would be available.

Finally, we make a number of suggestions regarding the computation of adjustments under section 481(a), including that separate determinations of approach be permitted for differing items, that simplifying conventions be made available (such as the methods provided in Regulation section 1.263A-7(c)(2)), and that taxpayers be permitted to request a cut-off method change when circumstances warrant.

¹⁰ If the adjustment is positive, the Service's administrative procedures generally provide that the section 481(a) adjustment may be taken into account over the four taxable years beginning with the year of the change. If the section 481(a) adjustment is negative, it is included in income in the year of the change. If the section 481(a) adjustment creates a net operating loss ("NOL"), the typical NOL rules apply. *See e.g.*, Rev. Proc. 97-27, 1997-1 C.B. 680; Rev. Proc. 2008-52, 2008-36 I.R.B. 587.

DETAILED DISCUSSION

These Comments are prepared in response to the Notice of Proposed Rulemaking (REG-168745-03) published in the Federal Register on March 10, 2008 (the “Proposed Regulations”). Section 263(a) requires taxpayers to capitalize expenditures made to improve or increase the value of property or to restore the exhaustion of property for which an allowance has been permitted, such as depreciation. The Proposed Regulations prescribe rules and standards regarding the application of section 263(a) to amounts paid to acquire, produce, or improve tangible property. As a general rule, the Proposed Regulations confirm that a taxpayer must capitalize the costs of acquiring or producing tangible property as well as certain costs that facilitate the acquisition. A taxpayer that incurs costs to repair an asset after it has been placed in service must determine the relevant unit of property and then capitalize costs to the extent that the expenditures result in an improvement to that unit of property.

For this purpose, the Proposed Regulations provide a three-part test for distinguishing between deductible repair expenses and capital expenditures. Expenditures are capitalized to fixed assets if the costs result in: (i) a betterment; (ii) a restoration; or (iii) a new or different use with respect to the unit of property. The Proposed Regulations clarify the standards included in current Regulations under section 263(a) and also in the 2006 Proposed Regulations. The Proposed Regulations simplify the rules for determining a unit of property and provide guidance to simplify the determination of whether assets must be accounted for as materials and supplies.

The betterment standard in Proposed Regulation section 1.263(a)-3(f) replaces the so-called “increase in value” test in the 2006 Proposed Regulations. The Preamble indicates that “betterment” is more descriptive of what the test seeks to identify: expenditures that result in a qualitative improvement to the asset as opposed to a quantitative increase in fair market value. Expenditures result in a betterment of a unit of property in three situations: (i) the remediation of a material defect that existed prior to the acquisition or that arose during production of the unit of property; (ii) a material addition to the unit, such as an enlargement, expansion, or extension; and (iii) a material increase in the capacity, productivity, efficiency, strength, quality, or output of the unit of property. The determination of whether an expenditure is within one of these situations is made by comparing the condition of the unit of property after the expenditure with the condition of the property prior to the condition or event necessitating the expenditure.

The proposed rules for determining whether property has been restored are significantly modified in Proposed Regulation section 1.263(a)-3(g). Under the 2006 Proposed Regulations, expenditures were required to be capitalized if they extended the property’s period of usefulness beyond the end of the taxable year following the end of the taxable year in which its original economic life ended, with a presumption that the property’s economic life was co-extensive with the economic life assigned for financial reporting purposes.

The restoration test under the Proposed Regulations continues to seek to identify those expenditures that materially prolong the useful life of an asset, relying on six objective standards: (i) replacement of a component of a unit of property when the taxpayer has properly deducted a loss for that component; (ii) replacement of a component when the taxpayer has

taken into account the adjusted basis in realizing gain or loss on a sale or exchange of the component; (iii) repair of damage to a unit of property when the taxpayer has taken a basis adjustment as a result of a casualty event (whether or not a casualty loss is deducted); (iv) return of the unit of property to its ordinary efficient operating condition after it was in a state of disrepair and no longer functional, at any time in the property's existence; (v) rebuilding of a unit of property to a like-new condition after the end of both its economic useful life to the taxpayer and the section 168(c) recovery period that would apply to the property; (vi) replacement of a major component or substantial structural part of a unit of property after the end of its section 168(c) recovery period.

Proposed Regulation section 1.263(a)-3(h) provides that capitalization is required when a taxpayer incurs expenditures that change the taxpayer's use of the property. A new or different use is one that is not consistent with the taxpayer's intended ordinary use of the unit of property when the taxpayer originally placed it in service. Several examples are given, which generally address situations involving a change in the use of the entire unit of property.

We commend the Service and Treasury for re-proposing Regulations regarding the deduction and capitalization of expenditures related to tangible property. These Proposed Regulations address a number of concerns identified by taxpayers, commentators, and practitioners regarding the 2006 Proposed Regulations. A number of bright-line rules have been provided and certain critical terms used in this area have been defined, which may not only reduce the cost of recordkeeping and compliance burdens of taxpayers, but may also increase the efficient use of the government's administrative resources.

We believe application of the principles included in the Proposed Regulations would result in greater taxpayer compliance and a more efficient and fairer tax system. The principal goal of the following Comments is to identify additional issues that it would be useful to address when the Proposed Regulations are finalized and to suggest refinements intended to better achieve the goals of the Proposed Regulations.

The order of our comments follows the order of the Proposed Regulations. Nonetheless, we believe our comment regarding the treatment of repairs in connection with a casualty is most significant. The proposed treatment reflects a significant change to existing law that would affect a large group of taxpayers in a variety of industries making repairs to property that has been subject to a casualty loss. We request that this proposed position be subject to serious reconsideration as the Regulations are being finalized.

A. Expansion of the Special Exception for Transaction Costs to All Property Acquisitions

We commend the Service and Treasury for including a special rule that allows taxpayers to deduct costs incurred to investigate whether to acquire real property, and which real property to acquire. For fairness and to make the rules less complex, we suggest that the final Regulations expand this exception to acquisitions of all tangible property, both real and personal.

Proposed Regulation section 1.263(a)-2(d)(1)(i) specifies that a taxpayer must capitalize amounts paid to acquire or produce a unit of property, and that these amounts include the invoice price and costs for work performed prior to the date the unit of property is placed in service by the taxpayer, as well as transaction costs. The rules that define transaction costs in this context are patterned after the capitalization principles for the acquisition and creation of intangible assets, and the exclusions are modeled after the exclusions for pre-decisional investigatory costs provided with respect to certain intangibles in Regulation section 1.263(a)-4(e)(1)(iii) (creation of certain contract rights) and Regulation section 1.263(a)-5(e) (acquisition of a trade or business).

Costs generally are required to be capitalized if they facilitate the acquisition of real or personal property or if they are incurred in the process of investigating or otherwise pursuing the acquisition of property. The Proposed Regulations provide a limited exception for costs that otherwise would be capitalized under this general rule when the costs are incurred in the process of determining whether to acquire real property and which real property to acquire. Specifically, Proposed Regulation section 1.263(a)-2(d)(3)(ii)(C) provides:

[E]xcept as provided in paragraph (d)(3)(ii)(B) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire.

The Preamble indicates that this “whether and which” rule was included in response to suggestions from commentators that an exception should be provided for transaction costs that are pre-decisional investigatory costs, similar to the exception provided with respect to certain intangible costs.¹¹ As noted in the Preamble:

[T]hese types of transactions most often raise the issue of whether the investigatory costs are deductible business expansion costs rather than capital expenditures to acquire a specific asset. The exception provides that costs relating to activities performed in the process of determining whether to acquire real property and which real property to acquire generally are deductible pre-decisional costs.¹²

Although the exception no longer requires taxpayers to allocate investigatory costs among various real property acquisitions, when a taxpayer is investigating the feasibility of acquiring a group of assets in a single transaction that include a combination of real and personal property (*e.g.*, an office building and related assets that are not structural components), the investigatory costs must be allocated between the real and personal property. To the extent that costs are attributable to the personal property, such costs would be capitalized whereas costs attributable to investigating real property would be deductible.

¹¹ Preamble at 12,840.

¹² *Id.*

The Preamble notes that the exception for investigatory costs was included to reduce complexity in allocating investigatory costs between property acquired and investigatory costs attributable to property that was not acquired. Extending the exception to all property acquisitions would similarly eliminate complicated allocations among various personal property acquisitions, as well as between real and personal property in situations involving acquisitions of a mixed group of assets in a single transaction. If this change is not made, we have concerns that the rules may remain unnecessarily complicated and relatively unfair to companies acquiring personal property. With respect to tangible property acquisitions, therefore, we recommend the final Regulations apply this rule without limitation to tangible property, whether an acquisition involves real or personal property.

B. De Minimis Rule for Acquisitions

The Proposed Regulations contain a de minimis rule permitting certain taxpayers to deduct the cost of acquiring or producing low-cost personal property. The 2006 Proposed Regulations did not provide a specific de minimis rule for the acquisition or production of property, and the Preamble to the Proposed Regulations states that a de minimis rule was added “to reduce burden and provide simplification.”¹³

In particular, Proposed Regulation section 1.263(a)-2(d)(4) provides that a qualifying taxpayer may immediately deduct the costs of acquiring or producing property for tax purposes applying the de minimis standard adopted in its financial statements, provided that deducting these de minimis amounts does not result in a distortion of income. The Regulations provide that the de minimis rule is available for acquisitions if: (i) the taxpayer has an AFS; (ii) the taxpayer has a written accounting procedure treating as an expense for non-tax purposes the amounts paid for property costing less than a certain dollar amount; (iii) the taxpayer treats the amount paid during the taxable year as an expense on its AFS in accordance with its written accounting procedures; and (iv) the total aggregate of amounts paid and not capitalized do not distort the taxpayer’s income for the taxable year. The Preamble states: “[A]ccounting for an item using generally accepted accounting principles would not result in a distortion of income. Nonetheless, a distortion of income standard has been adopted in an effort to avoid intentional manipulations of the de minimis rule.”¹⁴

The Proposed Regulations provide a quantitative safe harbor for when a de minimis standard that is used as part of the taxpayer’s AFS¹⁵ is deemed not to distort income. Under

¹³ Preamble at 12,840-41.

¹⁴ Preamble at 12,841.

¹⁵ A similar AFS standard was adopted initially in section 4.06 of Rev. Proc. 2004-34, 2004-1 C.B. 991, which provides guidance for the tax accounting treatment of advance payments received by accrual-method taxpayers. The Proposed Regulations deviate from the standard used in the advance-payments rules in that the revenue procedure uses the AFS as a bright-line rule for expensing, on the theory that deferral for GAAP is deemed to clearly reflect income, whereas the Proposed Regulations impose an additional test under which the AFS results can be considered to distort income such that the safe harbor does not apply. As discussed in the text, we suggest that, in this context, financial statements prepared in accordance with GAAP, IFRS, or other

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the safe harbor, an amount deducted for financial purposes is not distortive if that amount, when added to the amounts deducted in the taxable year as materials and supplies for units of property costing \$100 or less, is less than or equal to the lesser of (i) 0.1% of the taxpayer's gross receipts for the taxable year, or (ii) two percent of the taxpayer's total depreciation and amortization for the taxable year as determined in its AFS.¹⁶

We appreciate inclusion of a de minimis rule in the Proposed Regulations. Additionally, we applaud the Service and Treasury for making clear in the Preamble that the adoption of such a rule does not "affect any current understandings between examining agents and taxpayers with respect to the size and character of transactions that will be the focus of examinations."¹⁷ By eliminating the unit of property analysis for costs meeting the de minimis rule, the Proposed Regulations achieve significant simplification. Nonetheless, we are concerned that the simplification achieved with the de minimis rule may be diminished by the imposition of the annual requirement that a taxpayer demonstrate that its use of the de minimis rule is not distortive.

The annual material distortion test requires the compilation of information that is not routinely maintained because in general taxpayers deduct de minimis amounts and thus do not otherwise account for these amounts. Consequently, the test would impose a significant administrative burden to determine whether the taxpayer's AFS de minimis amount qualifies as "non-distortive." To qualify, a company would be required to annually measure its de minimis purchases against the year's gross receipts and combined depreciation and amortization, which would not be known until the end of the year. If the de minimis amount failed to qualify, the taxpayer would be required to account for each purchase during the year. Thus, a taxpayer would not know for certain until the end of the year whether it would be eligible to use the de minimis rule, and therefore the taxpayer would be required to maintain records throughout the year against the possibility that it might fail the test. Requiring the annual testing for all taxpayers would work counter to the goals of reducing burden and providing simplification for taxpayers.

We suggest that the de minimis rule would better achieve its stated goals if the de minimis amount is not subject to an additional annual test for material distortion when the taxpayer's AFS is prepared in accordance with GAAP, IFRS, or other mandated accounting standards (such as regulatory accounting standards). With respect to an AFS that is not prepared in accordance with GAAP, IFRS, or other mandated financial reporting standards, we suggest that the annual material distortion test of Proposed Regulation section 1.263(a)-

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applicable financial reporting standards, provide an adequate safeguard for clearly reflecting taxable income given that amounts that are material for the taxpayer generally would be required to be capitalized.

¹⁶ Prop. Reg. § 1.263(a)-2(d)(4); *see also* examples in Prop.Reg. § 1.263(a)-2(d)(4)(vii).

¹⁷ Preamble at 12,841.

2(d)(4)(i)(D) be applied to test distortion as implemented through Proposed Regulation section 1.263(a)-2(d)(4)(iii).

We believe this approach would sufficiently guard against intentional manipulations of the de minimis rule. As the government acknowledges in the Preamble, accounting for an item using GAAP does not result in a distortion of income. We recommend that the final Regulations explicitly incorporate this view. We also recommend that the final Regulations expand this approach to include financial statements prepared in accordance with IFRS and other applicable financial reporting standards. With the de minimis rule explicitly tied to the use of a financial statement subject to GAAP, IFRS, or other mandated accounting standards, we believe it is not necessary to provide any additional test regarding distortion. These financial accounting standards aim to match expenses with income and generally only permit expensing of amounts that provide a future benefit when the amounts are not material. Thus, these accounting standards may be relied upon to address any government concerns regarding distortions for tax purposes, without imposing a new and burdensome annual computational requirement.

Further, the Proposed Regulations only provide a de minimis rule for taxpayers that have an AFS. This approach does not offer simplification for taxpayers without an AFS, which includes many small business taxpayers. We believe that the same goals of simplification and burden reduction that motivated the proposed de minimis rule also support a less ambitious de minimis rule for other taxpayers. Accordingly, we recommend that the final Regulations include another de minimis rule for taxpayers without an AFS to provide simplification to all taxpayers. The proposed rule might provide, for example, a bright-line dollar threshold, indexed for inflation.

We also have two other comments. First, we request that the Preamble to the final Regulations reiterate that in lieu of applying the de minimis rule, taxpayers may rely on agreements reached between examining agents and taxpayers as to the determination of an appropriate de minimis threshold. The Preamble to the Proposed Regulations clarifies the government's view that the de minimis rule does not disturb any current understandings between examining agents and taxpayers with respect to the size and character of de minimis amounts. Restating this position in the Preamble accompanying the final Regulations would eliminate any confusion regarding whether this remains the view of the government.

Second, we suggest that the final Regulations (or other accompanying guidance) specify the treatment of de minimis amounts for purposes of accounting method changes. Case law has concluded that a change in the de minimis threshold for financial accounting purposes (*e.g.*, when a de minimis amount is changed on a financial statement) does not require a corresponding change in method of accounting for tax purposes.¹⁸ Nonetheless, in certain

¹⁸ For example, in *Cincinnati, New Orleans & Texas Pacific Ry. v. United States*, 424 F.2d 563 (Ct. Cl. 1970), an accrual method railroad was subject to the supervision of the Interstate Commerce Commission ("ICC"). Prior to 1970, the ICC required that rail carriers expense purchases of certain property costing less than \$100, and in 1970, the \$100 level was raised to \$500. For tax purposes, the railroad followed its ICC accounting practice. Following the ICC change, the Service allowed the taxpayer's deductions for items costing less than

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circumstances, the Service has asserted that such a change does require a corresponding change in method of accounting. Because the change may be prompted by a change in the taxpayer's financial statement, which is generally a change in facts, we believe that the change is not an accounting method change. If the Service chooses to address situations in which such a change in treatment for tax purposes requires an accounting method change for tax purposes, then we recommend that these changes be available under applicable automatic procedures¹⁹ and on a cut-off basis (*i.e.*, without any adjustment under section 481(a)).

C. Treatment of Replacement Parts and Interaction with Materials and Supplies under Regulation Section 1.162-3

Commentators noted that the 2006 Proposed Regulations did not specifically address the interaction between the 2006 Proposed Regulations and the treatment of materials and supplies under Regulation section 1.162-3. Under this provision, the cost of property treated as materials and supplies is not deductible until the property is used or consumed unless the items are considered *incidental* materials and supplies for which no records of consumption are maintained. Regulation section 1.162-3 provides immediate deduction for the cost of incidental materials and supplies that are not tracked. Commentators noted that under the 2006 Proposed Regulations, tangible property with a useful life of 12 months or less was not treated as materials and supplies, which was inconsistent with existing authorities regarding when to deduct amounts paid to acquire such property. Because the 2006 Proposed Regulations were inconsistent with the treatment allowed under Regulation section 1.162-3, uncertainty arose with regard to which provision (Regulation section 1.162-3 or the 2006 Proposed Regulations) would be applied to which property.

We commend the Service and Treasury for providing specific guidance in the Proposed Regulations with respect to this issue. Proposed Regulation section 1.162-3(d)(1) defines materials and supplies as tangible property that is either (a) not a unit of property, (b) a unit of property with an economic useful life of 12 months or less, (c) a unit of property that costs \$100 or less, or (d) identified as a material and supply in future guidance. Although we appreciate this clarification, we suggest a refinement of these rules when final Regulations are issued.

As background, under the Proposed Regulations, the costs of non-incidental materials and supplies are deducted as the materials and supplies are used or consumed, and the costs of

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\$100. The Service argued that use of the \$500 minimum constituted a change in accounting method for which consent had not been received. The court disagreed, stating that the increase in the minimum amount resulted from a change in facts and not from a change in accounting method. *See also Baltimore and Ohio RR v. United States*, 603 F.2d 165 (Ct. Cl. 1979) (finding that a change in method of valuing assets for depreciation purposes was not a change in method of accounting but a change in fact).

¹⁹ See Rev. Proc. 2008-52, 2008-2 C.B. 587, as amplified, clarified, and modified by Rev. Proc. 2009-39, 2009-38 I.R.B. 371, as corrected by Announcement 2009-67, 2009-38 I.R.B. 388.

incidental materials and supplies are deducted as the costs are incurred. The Proposed Regulations also provide that rotatable and temporary spare parts are considered used or consumed in the taxable year in which the taxpayer disposes of the parts.²⁰

Proposed Regulation section 1.263(a)-2(d)(4) provides that a taxpayer may elect to deduct the aggregate cost of property, including supplies, at the time of purchase, if the taxpayer's aggregate current deduction for property meets the requirements of the de minimis rule. Although the Proposed Regulations do not explicitly exclude property otherwise treated as materials and supplies from the de minimis exception, this exclusion may be inferred from the safe harbor test in Proposed Regulation section 1.263(a)-2(d)(4)(iii), which suggests that a taxpayer making a de minimis election would still be required to treat property costing \$100 or less as materials and supplies.

Thus, a taxpayer could be subject to five separate timing rules with respect to property otherwise considered materials and supplies: (i) they may be deducted when acquired because they are considered incidental and no record of consumption is maintained under Regulation section 1.162-3; (ii) they may be deducted when used or consumed because they are not incidental under Regulation section 1.162-3 or a record of consumption is maintained; (iii) they may be deducted when disposed of because they are considered rotatable spare parts; (iv) they may be deducted when acquired because they meet the de minimis rule; and (v) they may be capitalized and accounted for as a depreciable asset if the taxpayer elects. These varied rules necessitate a burdensome analysis, as well as complex record keeping.

To reduce this burden and complexity, we recommend that the final Regulations provide that a taxpayer electing to use the de minimis exception is entitled to apply the de minimis exception to all property acquired or produced, including material and supplies. Because materials and supplies seem to be the very type of property that should properly be characterized as de minimis, it seems unusually complicating to require taxpayers to parse its property costs between properties costing \$100 or less from more expensive materials and supplies, which are otherwise eligible for the de minimis rule under the taxpayer's financial reporting. While we recognize that this simplifying measure would not be available to all taxpayers,²¹ this proposal would provide welcome simplification for many taxpayers.

D. Treatment of Rotable Spare Parts

Under current law, rotatable spare parts that are not inventory may be accounted for either under (i) a depreciation method under section 168 or (ii) as materials and supplies under Regulation section 1.162-3. Under the general rules of depreciation, fixed assets with a useful

²⁰ The Preamble indicates that this rule prevents taxpayers from prematurely deducting the cost of a unit of property by systematically replacing components with rotatable spare parts. We address the treatment of rotatable spare parts in more detail in the following section.

²¹ For example, manufacturers subject to section 263A would still be required to capitalize materials and supplies used in manufacturing.

life of more than one year are subject to depreciation, whereas the cost of materials and supplies that must be treated as a deferred expense is deductible when the materials and supplies are consumed, subject to being included in inventoriable costs under the uniform capitalization rules of section 263A. Thus, rotatable spare parts accounted for as depreciable assets are subject to cost recovery beginning when the items are placed in service. Because property is considered placed in service when it is available for use, rather than when actually used, the costs of depreciable assets such as rotatable spare parts are invariably recovered sooner than the deferred costs of materials and supplies, which generally are recovered when actually consumed or used in operations (*e.g.*, when placed on an operating machine).

In the case of rotatable spare parts, a taxpayer typically removes a broken part from a machine or other equipment, replaces it with a functioning part, and then repairs the broken part. If the part is treated as materials and supplies in accordance with Regulation section 1.162-3, the taxpayer may claim a deduction for the difference between the cost of the replacement part and the fair market value of the broken part. When the broken part is repaired, the cost of repair is capitalized so that the basis of the part is the fair market value of the broken part plus the repair costs.²²

Under the Proposed Regulations, if rotatable spare parts are accounted for as materials and supplies rather than as depreciable property, the cost of a rotatable spare part would not be recovered until the taxpayer actually disposes of the part. Proposed Regulation section 1.162-3(b) provides the following definition and rule regarding rotatable spare parts and temporary spare parts:

[R]otatable spare parts are parts that are removable from the unit of property, generally repaired or improved, and either reinstalled on other property, or stored for later installation. Temporary spare parts are parts that are used temporarily until a new or repaired part can be installed, and then removed and stored for later (emergency or temporary) installation. . . . [R]otatable and temporary spare parts are used or consumed in the taxpayer's business in the taxable year in which the taxpayer disposes of the parts.

Thus, even though a rotatable spare part has been used as a replacement part in a repair, the cost would not be removed from the taxpayer's materials and supplies account, and the cost would not be recoverable through depreciation even though the part has been placed in service. As such, the cost of the repaired part would neither be depreciable nor deductible until the taxpayer disposes of the part. This change would depart from current law and would defer significantly the time when the costs of these spare parts may be recovered. The deferral required under the Regulations would be especially significant when compared to the treatment of non-rotatable spare parts, which are considered used or consumed when the spare parts are installed in machinery or equipment. The change would be all the more significant because the *de minimis* rule would further accelerate cost recovery for many substantially similar items.

²² See Rev. Rul. 69-370, 1969-2 C.B. 34, which describes how to account for non-functioning parts that are removed from a taxpayer's machinery or equipment, repaired, and reused.

Moreover, if the proposed treatment of rotatable spare parts were retained, we believe that the resulting delay in cost recovery would lead taxpayers to depreciate the parts in all cases, thereby rendering the proposed alternative treatment as a material and supply meaningless. While we applaud retention of the ability to depreciate rotatable spare parts, we also agree there is a need for a meaningful alternative treatment as a material and supply. We recommend that this alternative be based on the existing rules, which have not proven to be deficient.

Thus, we suggest that the final Regulations eliminate the rule that rotatable spare parts are not used or consumed until the taxpayer disposes of the parts. We further recommend that the Regulations, when finalized, retain the current regime for the timing of cost recovery for rotatable spare parts.²³

E. Use of Financial Reporting Life in the Routine Maintenance Safe Harbor

Under Proposed Regulation section 1.263(a)-3(e)(1), an amount paid for routine maintenance is deemed to not improve that unit of property and therefore may be deducted. Routine maintenance is characterized as “recurring activities that a taxpayer expects to perform as a result of the taxpayer’s use of the unit of property to keep the unit of property in its ordinarily efficient operating condition.” For this purpose, activities are routine *only if* the taxpayer expects, when the property is placed in service, to perform the activities more than once during the class life of the property. A unit of property’s class life is defined generally as the recovery period provided for the property under section 168(g)(2) and (3) for purposes of the alternative depreciation system.

We applaud the Service and Treasury for including this safe harbor, which provides guidance regarding when the cost of routine maintenance activities would be considered deductible. This safe harbor would provide welcome simplification for taxpayers evaluating whether particular types of expenses qualify as deductible maintenance. Moreover, we believe it would reduce future controversy regarding the deductibility of routine maintenance costs.

In order that the safe harbor more accurately reflect the economic realities of each taxpayer, however, we suggest the safe harbor be revised to include the option of using the

²³ Under this recommendation, to the extent that rotatable spare parts are depreciable, the costs are depreciable over a period equal to the life of the machinery or equipment in which parts may be installed. To the extent that rotatable spare parts are treated as materials or supplies, when a non-functioning part is removed from machinery or equipment that the taxpayer intends to repair, the taxpayer may claim a deduction for the difference between the cost of a new part and the fair market value of the non-functioning part removed from the machinery or equipment. When the non-functioning part is repaired, the cost of the repair is capitalized and added to the fair market value of the previously non-functioning part to determine its basis. Subsequently, when the repaired part is used, the taxpayer may deduct the adjusted basis of the part. Further, consistent with current law regarding materials and supplies, the replacement of a rotatable spare that is part of a larger unit of property does not trigger a retirement of the larger property. Instead, the machinery or equipment that was repaired continues to be depreciated over the remaining recovery period of the machinery or equipment.

asset's life determined under GAAP, IFRS, or other mandated accounting standards (such as regulatory accounting standards). Exclusive reliance on the class life of a unit of property to determine whether certain expenses are routine maintenance may not represent the actual useful life of the asset. The useful life determined under GAAP, IFRS, or other mandated accounting standards, may be a more accurate baseline for the determining whether an expense is merely maintaining the asset in working order and as such, that the expense is routine. Because the treatment under GAAP, IFRS, or other mandated accounting standards is equally objective, we believe this alternative would continue to meet the laudable goals of the safe harbor.

For the foregoing reasons, we recommend that the final Regulations permit taxpayers to use a unit of property's useful life under GAAP, IFRS, or other required accounting regime when determining whether maintenance is routine.

F. The Special Casualty Loss Rule

The 2006 Proposed Regulations required capitalization of the cost of any repairs to property subsequent to a casualty loss. Despite suggestions from taxpayers, the Proposed Regulations continue this significant change to current law. Specifically, the Proposed Regulations deem a repair after a casualty to be a restoration of the property requiring capitalization of costs.²⁴ The Preamble sets forth the reasons for the decision to retain this rule, which are grounded in concerns for consistency among taxpayers and a view that such an expense can never be sufficiently "ordinary" to warrant deduction. Nonetheless, the Preamble recognizes that in some industries extraordinary losses may be ordinary occurrences, and the Preamble encourages comments on this issue.

We are responding to this request for comment on how the Proposed Regulations should handle circumstances in which extraordinary losses give rise to ordinary expenses. After a close analysis of the issue raised in the Preamble, we believe that the better approach is to eliminate the special rule for repair costs subsequent to a casualty loss, thereby retaining the general rules contained in the Proposed Regulations. We suggest this would be more consistent with the historical treatment of such costs, with the purposes of section 165, with the most recent indications of the view of Congress, and with the goal of providing similar treatment to similarly situated taxpayers. If this recommendation is not adopted, we request in the alternative that the final Regulations make explicit the indication in the Preamble that a taxpayer may avoid this rule by forgoing any casualty loss otherwise available under section 165.

²⁴ See Prop. Reg. § 1.263(a)-3(g)(1)(iii).

The original Internal Revenue Act permitted a casualty loss deduction,²⁵ and interpretative Regulations have remained essentially unchanged for approximately 50 years.²⁶ Generally, the Regulations allow taxpayers to recognize a loss attributable to “fire, storm, shipwreck, or other casualty.”²⁷ The amount of a casualty loss deduction is the difference between the fair market value of the property immediately before and after the casualty,²⁸ which may be established either through appraisal or by reference to the costs required to repair damaged property.²⁹ A casualty loss deduction is limited to the adjusted basis in the damaged property, and the property’s basis must be reduced by the amount of any casualty loss deduction.³⁰ The casualty loss rules allow taxpayers to reduce property basis even if the post-casualty value of the property is greater than the outstanding basis and even if the impact of the casualty on the entire unit or components of the unit of property is minor. Thus, the deduction does not appear to be grounded in the tax-accounting policy concerns for matching income and expense or on the view that the casualty necessitates a replacement of the entire unit or its components. Instead, the casualty loss provisions reflect a longstanding policy of allowing taxpayers to accelerate a future tax benefit (*e.g.*, depreciation) to soften the economic effect of a current casualty, even when the economic loss may be to unrealized appreciation. Further, the casualty loss deduction is permitted even for personal use property not normally considered in computing taxable income.

The Preamble provides several reasons for the decision to retain the new rule for repairs following casualty losses. First, the Preamble states

significant authority implies that a casualty-type event generally may only be characterized either as an extraordinary event (thus giving rise to a “loss” under section 165), or as an ordinary and necessary event in the operation of a trade or business (thus giving rise to an ordinary and necessary deduction under section 162). See, *e.g.*, *R. R. Hensler, Inc. v. Commissioner*, 73 T.C. 168, 179 (1979), acq., (1980-2 CB 1); *Hubinger v. Commissioner*, 36 F.2d 724, 726 (2d Cir. 1929), cert. denied, 281 U.S. 741 (1930).

²⁵ Tariff of 1913, Ch. 16, 38 Stat. 114 (1913), Section II(B). The history of section 165 and of the Service’s approach to casualties is described more fully in David Jacobson, *Casualty Repairs Under the Proposed Capitalization Regs.*, 120 Tax Notes 961 (Sept. 8, 2008).

²⁶ See T.D. 6445, 1960-1 C.B. 93.

²⁷ Reg. § 1.165-7(a)(1).

²⁸ Reg. § 1.165-7(b).

²⁹ Reg. § 1.165-7(a)(2)(ii). Repair is not required for a casualty loss deduction but the cost of repairs can be used to measure the amount of a taxpayer’s loss.

³⁰ Reg. § 1.165-7(b). The casualty loss rules also require that the basis of damaged property must be reduced by any casualty loss deduction. See Reg. § 1.1016-6(a).

It appears that the court in *Hubinger* followed this reasoning.³¹ Yet, this was based on a narrow definition of those “ordinary and necessary” expenses for which a deduction is permitted, and the Supreme Court soon thereafter rejected that narrow definition. In *Helvering v. Welch*,³² the Supreme Court pronounced the current state of the law:

Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.³³

Thus, an “extraordinary” event, including an extraordinary casualty loss, may give rise to deductions that are “ordinary and necessary” in the sense used in section 162. Therefore, the extraordinary nature of a casualty loss may not provide any logical inference regarding whether subsequent costs constitute restoration (deductibility). Instead, we believe the proper question is whether impact of the expenditures constitutes a betterment or a mere repair. In addition, we believe the general rules of the Proposed Regulations are appropriate for making that determination.

The Preamble also suggests that capitalization of cost following a casualty loss is required to ensure consistent treatment among similarly situated taxpayers. It then contrasts the treatment of a taxpayer suffering a complete loss with a taxpayer that suffers only partial damage from the same event (*e.g.*, the same hurricane). The first taxpayer is required to capitalize the costs of replacing the property, but the second taxpayer might be able to deduct its costs as a repair.

We submit that the two taxpayers are “similarly situated” only in that they suffered loss through the same event. We believe that under settled law, as well as the rest of the Proposed Regulations, this is not a similarity that should have any legal relevance (any more than being from the same town or being in the same business) with respect to the repair vs. improvement question. The similarity that has meaningful relevance is the effect of the expenditure on the unit of property: Did the taxpayer improve the property or merely return it to its normal

³¹ The Second Circuit stated, “[A] replacement of damage from a devastating fire while perhaps a “necessary” expense cannot be regarded as an “ordinary” one. “Ordinary . . . expenses” in the most natural meaning of the words are those due to wear and tear and trifling accidental causes.” 36 F.2d 724 at 726 (ellipses in original).

In *R.R.Hensler, Inc.*, which is also cited by the Preamble, the court explicitly declined to reach the question: “[N]either party addresses the question of whether petitioner may be entitled to both a deduction under sec. 162 and a casualty loss deduction under sec. 165. . . . Consequently, we have not considered such issues.” 73 T.C. 168, *acq.* 1980-2 C.B. 1.

³² 290 U.S. 111 (1933).

³³ 290 U.S. at 112.

operating condition when compared to its condition prior to the casualty event, its condition immediately after the last maintenance event if the casualty superimposed the need for ordinary maintenance, or both? If the answers to this question are not the same, we believe the taxpayers are not similarly situated, and any difference in treatment is entirely appropriate. We believe the general rules of the Proposed Regulations are the best way to answer the questions.

We are not aware of any policy reason to deny simultaneous deductions under sections 162 and 165. As noted above, these two provisions serve different purposes. Section 263 and the “ordinary” requirement of section 162 both (in relevant part) go to requiring capitalization of expenses that give rise to new value to the unit of property. On the other hand, the mechanics of the casualty loss provisions of section 165 are grounded in the sudden, adverse impact of the casualty, no matter how minor the impact on the unit of property as a whole. We also do not believe that this is a “double deduction.” As that term is normally used, it means deducting the same expenditure twice. The two deductions here involve two different expenditures: the costs of repairing casualty damage and a portion of the original cost of the property.³⁴

A recent Joint Committee publication also indicates that these two provisions are available simultaneously. The Gulf Opportunity Zone Act of 2005³⁵ provided tax relief for victims of Hurricane Katrina. Section 1400N(k), as enacted by that Act, provides a special carryback rule for losses stemming from certain enumerated deductions, including casualty losses and repair expenses, to the extent attributable to Hurricane Katrina.³⁶ The Joint Committee’s 2005 technical explanation of the Act indicates that both casualty losses and repair expense deductions are available to victims of this single casualty.³⁷

For the reasons above, we recommend that the final Regulations omit the special rule of Proposed Regulation section 1.263(a)-3(g)(1)(iii) relating to expenditures subsequent to a casualty loss. Taxpayers that experience casualty losses, like all taxpayers, would therefore apply the remaining rules of the Proposed Regulations, including the other provisions of Proposed Regulation section 1.263(a)-(g), to determine whether the expenditures after the casualty result in improvements to the unit of property.

If this recommendation is not accepted, however, we alternatively recommend that the final Regulations explicitly state that a taxpayer that forgoes a casualty loss will not be subject to the special rule for expenditures following a casualty loss and that no basis reduction will occur under the flush language of section 1016(a)(2), which reduces basis for amounts

³⁴ The basis reduction required under Reg. § 1.1016-6(a) prevents any double deduction of the latter.

³⁵ Pub. L. 109-135, 119 Stat. 2585.

³⁶ See I.R.C. § 1400N(k)(2)(B)(i) (casualty losses), (ii) (repair expenses).

³⁷ Staff of J. Comm on Tax’n, *Technical Explanation of the Gulf Opportunity Zone Act of 2005* at 27 (JCX-88-05).

allowable even if not taken. The Preamble indicates that this is the intent of the drafters when it states, “capitalization is required only if a loss or basis adjustment to the property is recognized by the taxpayer with respect to the event.”³⁸

This approach would avoid having a minuscule casualty control the tax treatment of a much larger unrelated repair expenditure, some part of which may have been necessitated by ordinary wear and tear, had the casualty not intervened. Further, it avoids the burden of determining which expenditures following a repair addressed normal pre-existing deterioration and which addressed damage caused by the casualty. This is particularly important because efforts following a casualty often must be focused on fixing wide-ranging and life-threatening conditions. For example, emergency repair crews of an electric utility address all substandard conditions they find as they work to restore critical service to customers. Requiring them to analyze and document each item repair is not only burdensome, but counterproductive at the worst of times. Thus, we believe taxpayers should be allowed to forgo the casualty loss provisions and treat all such damage as repairs.

G. Transition Rules and Accounting Method Changes

The Preamble to the Proposed Regulations states that a change in the treatment of repair costs is a change in method of accounting. Although the Proposed Regulations do not include specific provisions regarding such accounting method changes, the Preamble states that the final Regulations will provide guidance and requests comments regarding accounting method changes under these provisions.³⁹ We welcome the opportunity to provide the following comments.⁴⁰

First, section 1.263(a)-3(n) of the Proposed Regulations provides that the section is applicable to amounts paid or incurred in taxable years beginning on or after the date the final Regulations are issued. A mid-year change in method of accounting for routine costs can be burdensome to implement. To encourage prompt compliance and reduce controversy on audit, we recommend that the final Regulations permit taxpayers to file an early request for change in method in the interim between issuance of the final Regulations and the beginning of the first year of application.

Further, we recommend that the final Regulations (or preamble) provide that taxpayers may rely on the final Regulations (other than any de minimis rules or safe harbor guidance) in taxable years prior to the effective date of the final Regulations. We believe the Proposed

³⁸ Preamble at 12,846.

³⁹ Preamble at 12,847.

⁴⁰ Although our recommendations below are phrased in terms of the final Regulations, we recognize that many of these issues may be more appropriately addressed in other guidance, such as a revenue procedure published concurrently with the final Regulations.

Regulations are intended to reflect the principles of current law,⁴¹ and we expect the final Regulations will be as well. Because a goal of the Regulations is to provide certainty in the application of the rules for repair and improvement costs and to reduce related audit controversy, we believe it would be appropriate to permit taxpayers to cite the principles in the final Regulations to support their treatment of these costs in tax periods prior to the effective date. We believe this would reduce the resources devoted to these issues and that devotion of resources to these issues would provide little benefit for the Service in light of the pending resolution of many issues on a prospective basis. Therefore, except with respect to the application of specific safe harbors and bright-line tests in the final Regulations, we recommend that the final Regulations explicitly permit taxpayers to rely on the principles in those Regulations for periods prior to the effective date.

Third, we suggest that automatic consent be provided to change a method of accounting to comply with the final Regulations. We suggest that taxpayers obtain such automatic consent by complying with the automatic consent procedures set forth in Rev. Proc. 2008-52.⁴² Consistent with the approach used in the final “intangibles” Regulations, we also recommend that the scope limitations of Rev. Proc. 2008-52 be waived for the first taxable year following the issuance of the final Regulations.⁴³ Further, we suggest that audit protection be provided generally for these accounting method changes except with respect to an issue under consideration in an ongoing examination. We believe allowing accounting method changes to be made with audit protection would encourage voluntary compliance with the final Regulations and would reduce controversies related to the former repair accounting methods.

Fourth, we recommend that method changes to comply with the final Regulations be made with an adjustment under section 481(a). As a general rule, when changing a method of accounting, a taxpayer must determine the cumulative difference in the taxpayer’s taxable income under its present accounting method as compared to its proposed accounting method, and this difference is taken into account as taxable income, either positive or negative, under section 481(a).⁴⁴ This is consistent with the effective date in Proposed Regulation

⁴¹ See, e.g., IRS News Release (IR-2006-130) (Aug. 21, 2006) accompanying Prop. Treas. Reg. §§ 1.263(a)-1 through 1.263(a)-3, 76 Fed. Reg. 161 (Aug. 21, 2006) (REG-168745-03), which provides that the “proposed regulations provide an overall framework that expands the standards in the current regulations by drawing on principles developed through case law.”

⁴²2008-2 C.B. 587, as amplified, clarified, and modified by Rev. Proc. 2009-39, 2009-38 I.R.B. 371, as corrected by Announcement 2009-67, 2009-38 I.R.B. 388.

⁴³ See, e.g., Reg. § 1.263(a)-4(p)(2) (providing “[a]ny limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting to comply with this section for its first taxable year ending on or after December 31, 2003”); see also Reg. § 1.263(a)-5(n)(2) (providing a similar rule for transaction costs in business acquisitions).

⁴⁴ If the adjustment is positive, the Service’s administrative procedures generally provide that the section 481(a) adjustment may be taken into account over the four taxable years beginning with the year of the change. If the section 481(a) adjustment is negative, it is included in income in the year of the change. If the section 481(a)

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section 1.263(a)-3(n) in that the new rules are proposed to be applicable to taxable years after finalization, rather than to expenses incurred in those years.

Our recommendation regarding the section 481(a) adjustment differs from the treatment of these adjustments provided in the final intangible Regulations. With those Regulations, there was concern that some taxpayers might seek accounting method changes with respect to decades-old corporate transactions, which would be difficult for the Service to examine. To eliminate this concern, the Service and Treasury provided that accounting method changes were only available with a modified section 481(a) adjustment. This rule was consistent with the direction specified in proposed guidance that taxpayers may not change a method of accounting in reliance on the rules contained in the Proposed Regulations until finalized.

We do not believe that a similar concern should be present with respect to these Proposed Regulations. In virtually all situations, accounting method changes under these Regulations would be attributable to currently held depreciable assets. Thus, the computation of any section 481(a) adjustment would involve current records and fewer past years. Permitting an adjustment under section 481(a) also would be consistent with recent practice of the Service. Unlike with the intangible Regulations, during the pendency of these Proposed Regulations, the Service has processed many accounting method changes involving repair costs, generally applying the principles of both the 2006 and 2008 Proposed Regulations. Until recently, the National Office of the Service processed these accounting method changes under the more carefully reviewed non-automatic procedures, and now they are granted under the automatic procedures. These method changes have been granted with a full section 481(a) adjustment. As a result, an issue of fairness also arises because many taxpayers already have been permitted a change in method using an adjustment under section 481(a).

Nonetheless, because the Regulations deal with large numbers of routine or incidental items and repairs, some taxpayers may lack the records necessary to precisely calculate the adjustment under section 481(a). We suggest three responses to this situation. First, although a single method change request may be filed to bring the taxpayer into compliance with the final Regulations, we recommend that the section 481(a) adjustment and its implications be determined separately for each item (or group of similar items). For example, we believe the lack of records with regard to one type of item (such as incidental materials and supplies) should not disallow the use of a section 481(a) adjustment for another type of item (such as repair costs). Second, we recommend that taxpayers with adequate information be permitted to use valid simplifying techniques to calculate the adjustment, such as an averaging convention similar to that provided in Regulation section 1.263A-7(c)(2).⁴⁵ Finally, we recommend the

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adjustment creates a net operating loss (“NOL”), the typical NOL rules apply. *See, e.g.*, Rev. Proc. 97-27, 1997-1 C.B. 680; Rev. Proc. 2008-52, 2008-36 I.R.B. 587.

⁴⁵ In general, under Regulation section 1.263A-7(c)(2)(v), a taxpayer using the dollar-value LIFO method of accounting for inventories may revalue all existing LIFO layers of a trade or business based on a three-year average method. The three-year average method is based on the weighted average percentage change in the current costs of inventory for each LIFO pool based on the three most recent taxable years for which the taxpayer

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final Regulations permit a taxpayer to change its methods of accounting with respect to particular items using a cut-off method that only looks to costs incurred in the year of change and beyond, while retaining audit protection. We recognize that the Service may wish to permit such changes only through a non-automatic process or through a private letter ruling.

Conclusion

We commend the Service and Treasury for re-proposing Regulations regarding the deduction and capitalization of expenditures related to tangible property. These Proposed Regulations clarify a number of complex and multi-faceted issues. We expect the Regulations, when finalized, will achieve their goals of increasing certainty and reducing controversy consistent with the principles of current law. We appreciate the opportunity to submit these Comments, which we believe will better permit the final Regulations to attain these goals.

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had sufficient information, which is typically the three most recent taxable years. This percentage change is known as a three-year revaluation factor, and it is applied to all layers for each pool in beginning inventory in the year of change. The three-year average method is available to any dollar-value LIFO taxpayer that complies with the requirements in the Regulation, regardless of whether the taxpayer lacks sufficient data to revalue its inventory costs using a facts and circumstances revaluation method. The three-year average method must be applied with respect to all inventory in a taxpayer's trade or business.