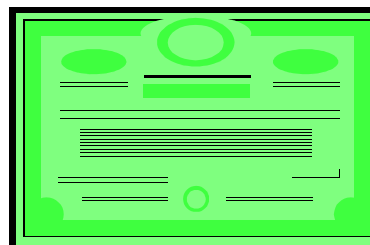


BUS 225H – Taxation of Property Transactions

Professor Annette Nellen

Week 2 Reading

- Basis
- Capitalization



In addition to the items in this reading packet, also read/review:

- Code and Regulations: §263, §263A, §266, §1011, §1012, §1014, §1015, §1016
- [*Indopco v. Commissioner*](#), 503 US 79 (1992)
- [*Crane v. Commissioner*](#), 331 US 1 (1947)
- “Tangible Guidance On Intangibles – New Section 263 Regulations Provide Taxpayers With Certainty,” *Business Entities*, Fall 2004, Purcell and Nellen - to be posted to Desire2Learn site

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- IV. After using the building for three years, ABC discovers that it is on a geological fault and is sinking. ABC incurs \$200,000 to keep the building from caving in. The cost did not add any value to the property or extend its useful life. How should ABC treat this expense?¹

3. What is the benefit of §266 to a taxpayer?

4. Ms. L owns the following shares of ABC stock:
- a. 100 shares purchased 2/1/X1 for \$60/share
 - b. 100 shares purchased 2/1/X2 for \$50/share

On 6/1/X6, L sells 50 shares of ABC stock. Which ones did she sell?

¹ *American Bemberg Corp.*, 10 TC 361 (1948), nonacq. 1948-2 CB 5, aff'd without opinion 49-2 USTC ¶9460, 38 AFTR 758 (6th Cir., 1949).

5. Mary inherited land from her grandfather. The grandfather's basis was \$150,000. The FMV at date of death was \$200,000 and \$220,000 six months after death.
 - a. What is Mary's basis in the land?

 - b. What is Mary's basis in the land if the grandfather's basis had been \$300,000?

 - c. What is Mary's basis in the land if the FMV at date of death had been \$220,000 and \$200,000 six months later?

6. In 1995, Joe received land as a gift from his father. At the time of transfer, the land was worth \$20,000. The father's basis had been \$24,000.
 - a. If Joe sells the land today for \$150,000, what is his gain?

 - b. If Joe instead sold the land for \$20,000, what would his gain or loss be?

 - c. If Joe had sold the land for \$21,000, what would his gain or loss be?

7. K Corporation failed to claim depreciation on one of its machines that it put into service 5 years ago. What is the effect of this on K's basis in the machine? Why? How should this problem be corrected (amended returns, Form 3115, something else)?

8. What is the rationale for the rule that when personal use property is converted to business use, its basis is the lower of adjusted basis or FMV at the conversion date?
9. Amy has Cisco stock worth \$50,000. In the current year, she sold it to her church for \$20,000. What is the tax treatment to Amy?
10. How should Ben treat legal fees incurred to defend a challenge to the title of his rental property?²
11. T's rental property was condemned by the state. T incurred legal fees to challenge the value set by the state and to receive interest on the delayed proceeds. T eventually received a higher payment for the property plus interest income. Should T deduct or capitalize the legal fees?³

² Regs. Secs. 1.212-1(k) and 1.263(a)-2(c) and origin-of-the claim doctrine of *Gilmore*, 372 US 39 (1963).

³ T must capitalize all of the attorney's fees. None of the fees can offset the interest income; the origin of the claim was the condemnation, and this is what T's attorney devoted his time to. There would have been no interest income if there had been no condemnation. *Jack Baylin*, 30 Fed. Cl. 248 (1993) and origin-of-the claim doctrine.

16. The Taxpayer Relief Act of 1997 made significant changes to the taxation of capital gains for individuals. The maximum rate on net capital gains was reduced from 28% to 20% (except for collectibles which remained at 28% and §1250 property gain due to depreciation was taxed at 25%). For capital assets with a holding period beginning after 2000, held for over 5 years, the capital gains rate would be 18% (rather than 20%) or 8% (if the rate would have been 10% (for lower bracket taxpayers)). Individuals with capital assets or §1231 property used in their trade or business on 1/1/01, could elect to treat the asset as having been sold for its FMV at that date. Thus, these assets would then be treated as having a holding period that allowed for the lower capital gains rates (if held over 5 years). This “deemed sale” or “mark-to-market” election would also change the basis of the asset. Assume you were advising client Tuan in December 2000 as to whether or not he should make this election for Cisco stock he purchased in 1998 with an unrealized gain at 1/2/01 of \$20,000. What would you tell Tuan?

17. What challenges might exist with the new basis reporting requirement for brokers?

What is “Basis”?

As described in §1012, basis is typically the “cost” of property. Per Reg. §1.1012-1(a), “The cost is the amount paid for such property in cash or other property.” In *Edwards v. Commissioner*, 19 TC 275, 279 (1952); acq. 1953-1 CB 4, the court noted that the regulations do not define “cost.” So, the court used the dictionary and found: “Cost, as defined in Webster’s New International Dictionary, is “the amount or equivalent paid, or given, or charged, or engaged to be paid or given for anything bought or taken in barter or for service rendered.” More succinctly and for our purposes, cost of the stock is the amount petitioner paid Paragon for the stock. This is the cost to petitioner.”

Sometimes, basis is the amount included in income. For example, if an employee has non-qualified stock options allowing him to purchase stock at \$10 when the market price is \$50, the \$40 per share spread is income to the employee. This income inclusion also affects the basis of the stock making the basis \$50/share (not \$10/share). Similarly, if your employer paid you with a car worth \$34,000, you’d have income of \$34,000 and the car’s basis in your hands would be \$34,000.⁴

The IRC provides special rules to determine the basis of property acquired by inheritance (§1014) and gift (§1015). IRC §1016 explains various basis adjustments including depreciation and the affect of losses.

Also, relevant to determine “basis” is understanding the rules on what costs/expenditures are included in the basis of an asset, such as costs to transport a machine so it can be used in the taxpayer’s factory. These rules are explained in §263 and §263A (including §263A(f) on when interest expense must be capitalized). Also relevant are rules on deductible repairs (§1.162-4 and numerous court cases). Detailed rules at §1.263(a)-4 and 1.263(a)-5 explain when expenditures that create intangible benefits or assets must be capitalized. These regulations were issued in response to numerous capitalization questions that arose after the *Indopco* case (also in this week’s reading).

Debt can also affect basis and this week’s reading provides an overview to these rules (the *Crane* case and a few others involving non-recourse debt).

⁴ See §1.61-2(d)(2), *Salvage*, 65 F2d 112, affd, 297 US 106.

Timing and Basis

Economic Performance: IRC §461(h), which provides an “economic performance” requirement, was added by the Deficit Reduction Act of 1984 as an additional requirement to the all events test to determine when an accrual method taxpayer may deduct an item. The rule applies beyond the timing of deduction though; it applies to determine when an item is incurred (see §461(h)(1)). Thus, it is relevant in determining when a capital expenditure affects basis, as stressed in the final §461(h) regulations issued in 1992 (TD 8408). The preamble to the regulations states:

The regulations define a liability as any item allowable as a deduction, cost, or expense, except for certain items for which the Code provides alternative timing rules. Thus, section 461(h) applies to allowable deductions and any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense.

Thus the regulations changed §§1.61-3, 1.263-1(a)(1) and 1.263A-1(a)(5) as well as §1.461.

Basically, under the economic performance (EP) rules, an item may not be considered, either as a deduction or addition to basis, until property or services are actually provided to the taxpayer (or costs are incurred by the taxpayer in providing services, as for example in the case of warranty work done for customers). For example, if a taxpayer were to prepay a management consultant for a two-year assignment, economic performance would only be met as the services are provided to the taxpayer. For certain types of items, such as taxes, economic performance is met when payment is actually made (§1.461-4(g)).

EP and Common Improvements of a Real Estate Developer: The economic performance rule also caused the IRS to question Rev. Proc. 75-25. This ruling allowed a real estate developer to elect a special accounting method to include the cost of common improvements in units that were sold. However, because it allowed costs not yet incurred to be considered in basis, the Rev. Proc. method was not in line with the EP rules. Rev. Proc. 75-25 was replaced with Rev. Proc. 92-29.

Rev. Proc. 92-29 attempts to reconcile the long-established theory allowing developers to include a ratable portion of common improvement costs in units as they are sold, with the fact that the use of estimates in basis is not allowed under the EP rules. The Rev. Proc. Provides a procedure for real estate developers to obtain IRS consent to use an “alternative cost method” (ACM) to account for the cost of common improvements, defined as any real property or improvement to real property that benefits two or more properties that are separately held for sale by the developer. Under the ACM, a developer may include in the basis of properties sold, their share of the “estimated cost of common improvements” with limited regard to the EP rules. The estimated cost of common improvements is defined as the amount of common improvement costs incurred under the EP rules as of year end, plus the amount of common improvements costs reasonably anticipated to be incurred under the EP rules during the 10 succeeding tax years (the “ten-taxable year horizon”). Under the ACM, the developer includes in the basis of property sold, its allocable share of the estimated cost of common improvements. The main limitation is that at the end of any tax year, the total amount of common improvement costs that has been included in basis may not exceed the amount of common improvements costs that have been incurred under the EP rules. This limitation is applied on a project by project basis. Rev. Proc. 92-29 explains the exact procedures for obtaining IRS consent, the five conditions a developer must meet, and examples of the ACM and the alternative cost limitation rule. A developer using the Rev. Proc. 92-29 method must file an annual statement with the District Director.

Example of EP Rule and the Determination of Property Basis: TAM 199904036 (full text)

ISSUES

- (1) When is the liability for payment of deferred sales tax associated with the acquisition of an asset incurred by the Taxpayer for purposes of section 461 of the Internal Revenue Code?

- (2) If the deferred sales tax is not incurred by the Taxpayer under section 461 of the Code until the year(s) of payment, and thus, not includible in the basis of the asset until the year(s) of payment, then how is the deferred sales tax taken into account for purposes of depreciation under section 168?

CONCLUSIONS

- (1) The liability for payment of deferred sales tax associated with the acquisition of an asset is incurred by the Taxpayer under section 461 of the Code in the year(s) in which payment is made, and not in the year in which the asset is purchased.
- (2) The Taxpayer must redetermine its depreciable basis in an asset in each taxable year in which a deferred sales tax payment is made with respect to that asset.

FACTS

The Taxpayer is a company that manufactures electronic components in State X and uses an accrual method of accounting. In the early 1990's, Taxpayer constructed a manufacturing and research facility, and pursuant to State X's sales and use tax deferral program for certain manufacturing or research and development investment projects, Taxpayer was able to defer payment of sales taxes related to the acquisition of qualifying buildings and equipment. Specifically, the Taxpayer applied for and received several deferral certificates by State X, which enabled the Taxpayer to defer "state and local retail sales tax and use tax due on the construction of buildings as well as the acquisition of qualified machinery and equipment to be used therein as an integral and necessary part of the manufacturing or research and development operation." The Taxpayer's payment of the deferred sales taxes is due in five installments. The first payment (10% of the total tax deferred) was due on December 31 of the third year after the construction project was operationally complete, and four subsequent annual payments (15%, 20%, 25%, and 30%, respectively) are due on December 31 of the following four years. Thus, the Taxpayer's first installment payment was due on Date 1.

At the time the Taxpayer purchased an asset eligible under State X's deferral program, the Taxpayer included the deferred sales tax in the determination of the asset's basis and began depreciating the asset at the time it was placed in service. The Taxpayer's first installment payment of the deferred sales taxes was made on or before Date 1. Thus, the Taxpayer's net amount of deferred sales taxes due was \$a for the taxable period ending on Date 2.

The agent has questioned whether the economic performance rules under section 461 preclude the Taxpayer from taking the deferred sales tax into account in determining the basis of an asset until the time when payment is made. The Taxpayer argues that the deferred sales taxes at issue were properly added to the basis of depreciable assets to which they relate as of the date of acquisition and that the economic performance rules should not apply to acquisition costs of depreciable assets. Moreover, if the deferred sales taxes are not properly added to basis until payment is made, the Taxpayer questions the correct method for computing depreciation deductions under section 168.

LAW AND ANALYSIS

Section 461(a) of the Code provides generally that the amount of any deduction or credit shall be accounted for in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.263(a)-1(b) of the Income Tax Regulations provides that the amount of any cost required to be capitalized under section 263 may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of section 1.446-1(c)(1)(ii).

Section 461(h)(1) of the Code generally provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 461(h)(4) of the Code provides that the all events test is met if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.

Section 1.461-1(a)(1) of the regulations provides that under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as deductions for depreciation, depletion, and losses under sections 167, 611 and 165, respectively.

Section 1.461-1(a)(2)(i) of the regulations provides, in part, that under an accrual method of accounting, a liability (as defined in section 1.446-1(c)(1)(ii)(B)) is incurred and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that a deductible liability is generally taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of 1.263A-1T(a)(5)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Code sections and guidance published by the Secretary.

Section 1.446-1(c)(1)(ii)(B) of the regulations provides, in part, that the term “liability” includes any item allowable as a deduction, cost or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. Thus, for example, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property.

Section 461(h)(2)(D) of the Code provides that in the case of a liability not described in sections 461(h)(2)(A), (B), or (C), economic performance occurs at the time determined under regulations prescribed by the Secretary.

Section 1.461-4(g) of the regulations provides that in the case of liabilities described in paragraphs (g)(2) through (7) of this section, economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed.

Section 1.461-4(g)(6) of the regulations provides, in part, that if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax.

Section 1.461-4(g)(1)(ii)(A) of the regulations provides that the term “payment” has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. Thus, for example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a governmental agency).

Section 167(a) of the Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, and wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business, or held for the production of income. For tangible depreciable assets placed in service after 1986, section 168 provides that the depreciation deduction provided by

section 167(a) shall be determined by using the applicable depreciation method, recovery period, and convention.

Generally, a taxpayer using an accrual method of accounting may not take an amount into account in computing its basis in acquired property until that amount is incurred. Sections 1.263(a)-1(b) and 1.446-1(c)(1)(ii)(B). The regulations under section 461 provide a three prong test to determine when an item is incurred and can be taken into account by taxpayers using an accrual method. Specifically, section 1.461-1(a)(2)(i) of the regulations provides that a liability is incurred and taken into account in the taxable year in which (i) all events have occurred to establish the fact of the liability, (ii) the amount of the liability can be determined with reasonable accuracy, and (iii) economic performance has occurred with respect to the liability. The agent has not questioned whether the first two prongs have been met, but has questioned whether economic performance occurs in the year in which the asset is purchased or in the year(s) in which the deferred sales tax is paid. Neither the agent nor the Taxpayer dispute the fact that the deferred sales tax liability is a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year within the meaning of section 263(a) and thus, is taken into account in the taxable year incurred through capitalization.

We believe section 1.461-4(g)(6) of the regulations clearly provides that taxes are among the liabilities requiring payment to another person in order for economic performance to occur. Moreover, the deferred sales taxes at issue are clearly the type of taxes covered by the regulations. Thus, economic performance does not occur for the deferred sales taxes until the taxes are actually paid by the Taxpayer to State X, and thus, the Taxpayer may not take the deferred sales tax into account in computing its basis in the depreciable assets until payment is made.

The Taxpayer argues that notwithstanding the literal language of the Code and regulations underlying section 461, the deferred sales taxes at issue should be included in the determination of its basis in acquired assets as of the date of acquisition for several reasons. First, the Taxpayer argues that the economic performance rules effectively place accrual method taxpayers on a cash method, and since cash method taxpayers can add acquisition costs to the basis of assets even if the asset was purchased on credit or with a debt instrument (i.e., even if payment for the asset was not made), accrual method taxpayers such as the Taxpayer should be allowed similar treatment. For support, the Taxpayer cites section 1.461-1(a)(1) of the regulations, which states that under the cash method of accounting, amounts representing allowable deductions as a general rule shall be taken into account for the taxable year in which paid, and a taxpayer using the cash method may also be entitled to certain deductions which do not involve cash disbursements during the taxable year, such as deductions for depreciation, depletion, and losses under sections 167, 611 and 165, respectively. Further, the Taxpayer cites *Crane v. Commissioner*, 331 U.S. 1 (1974), as authority for its assertion that property acquired by purchase has a basis equal to its cost, and cost includes money paid plus liabilities assumed. Thus, the Taxpayer argues that “depreciation is an exception to the general rule that a cash-basis taxpayer cannot deduct amounts not actually paid.” Accordingly, the Taxpayer argues that since “the payment rule effectively places an accrual method taxpayer on par with a taxpayer on the cash method of accounting, it is reasonable to allow an accrual method taxpayer to capitalize all costs associated with the acquisition of an asset regardless of when payment for the asset is made.”

We do not agree with the Taxpayers basic premise that the economic performance rules effectively place accrual method taxpayers on a cash method. Under section 1.461-1(a)(1), expenditures are to be deducted under the cash method for the taxable year in which paid. Thus, taxpayers using the cash method must simply make payment in order to deduct an expense. In contrast, however, a liability is only incurred and is taken into account for Federal income tax purposes by a taxpayer using an accrual method in the taxable year in which (i) all the events have occurred that establish the fact of the liability, (ii) the amount of the liability can be determined with reasonable accuracy, and (iii) economic performance has occurred with respect to the liability. Sections 1.446-1(c)(1)(ii)(A) and 1.461-1(a)(2)(i). We believe the standards applicable to cash method and accrual method taxpayers are different standards, and there is no indication in section 461 that Congress intended to provide uniform rules and results for all taxpayers using cash and

accrual methods of accounting. Moreover, we do not believe the Taxpayer's characterization of the tax treatment of depreciation deductions by cash method taxpayers is correct. The Taxpayer argues that depreciation is an exception to the general rule that a cash-basis taxpayer cannot deduct amounts not actually paid. Although a taxpayer using the cash method who finances the purchase of an asset is entitled to depreciate the full purchase price of the asset, that taxpayer is only entitled to do so because the taxpayer has incurred a current obligation and so payment has been made within the meaning of section 1.461-1(a)(1), and thus, that taxpayer is entitled to include the full purchase price of the asset in its depreciable basis. In contrast, a taxpayer who has not yet paid deferred sales taxes associated with the acquisition of an asset has not incurred the obligation and is not in the same position as a taxpayer who has paid for an asset, but has paid with borrowed funds. Under the cash method, actual payment is required before an expense can be deducted, and payment through a financing transaction meets the payment requirement. Thus, we do not agree that depreciation deductions are an exception to the general rule that a cash method taxpayer cannot deduct amounts not actually paid, rather depreciation deductions are allowed because in the case of a financed acquisition, there was a disbursement of borrowed cash. Moreover, although section 1.461-4(g)(1)(ii)(A) of the regulations provides that the term "payment" has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment, the regulations specifically provide that payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a governmental agency). Thus, even if the Taxpayer were correct in its characterization of the tax treatment of cash method taxpayers, these regulations clearly require actual payment by accrual method taxpayers without borrowed funds.

Second, the Taxpayer argues that if the Taxpayer is not allowed to take the deferred sales taxes into account in determining basis until payment is made, depreciation deductions in taxable years before payment of deferred taxes will not match the time period in which an asset is used to generate revenue, nor will the deductions match the cost of the asset with the time period in which the asset is used to generate revenue. The Taxpayer argues that in *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), the Supreme Court expressed two matching principles regarding depreciation. First, depreciation represents the exhaustion of an asset as it is actually consumed in a business, and second, depreciation deductions should correspond with the time period in which an asset is used to generate income. Thus, the Taxpayer argues that if depreciation deductions are not allowed until actual payment has been made, then the matching principle could be completely eliminated, especially in situations, for example, where an asset may have a useful life of three years, but payment is deferred for four years. We do not dispute the purpose of depreciation deductions as stated by the Supreme Court, however, we do not believe these matching principles are relevant to the issue at hand. Regulations under sections 461 and 446 specifically provide that a liability is not incurred and cannot be taken into account in the determination of the basis of an asset until payment is made. These authorities do not provide any different or special rules for depreciable assets. Moreover, it is not uncommon for the depreciable basis of an asset to be redetermined for a variety of reasons after the year of acquisition. Where there is a subsequent adjustment to the purchase price of an asset that changes the amount of depreciation that should have been taken, we do not require a taxpayer to readjust its purchase price and depreciation deductions as of the date of acquisition, but instead, allow the taxpayer to account for the adjustment in the year the adjustment occurs.

Accordingly, despite the Taxpayer's arguments, we believe the literal language of both the Code and regulations under section 461 supports the conclusion that economic performance for the liability for payment of the deferred sales tax occurs as payments are made in satisfaction of the liability. Accordingly, the Taxpayer may not take into account the deferred sales taxes in determining its basis of acquired assets until such payments are made.

Because we conclude that the Taxpayer may not include the deferred sales tax in the basis of related assets until the year(s) in which payment is actually made to State X, the Taxpayer questions what is the appropriate method for computing depreciation deductions for the assets in question. The Taxpayer must

treat the payment(s) of the deferred sales taxes as a redetermination of the sales price. Thus, for each of the taxable years in which the adjusted basis of an asset is redetermined because of a payment of the deferred sales taxes, the recovery allowance is the amount determined by multiplying the redetermined adjusted basis by the redetermined applicable percentage. For this purpose, the redetermined adjusted basis is the unadjusted basis reduced by the recovery allowance previously allowed or allowable to the taxpayer with respect to the property and adjusted to reflect the redetermination. The redetermined applicable percentage is the percentage determined by dividing the applicable percentage computed under either the method set out in Section 6 of Rev. Proc. 87-57, 1987-2 C.B. 687, 692, or by use of the optional tables set out in Section 7 of that revenue procedure, by an amount equal to the unrecovered percentage (i.e., 100% minus the applicable percentage for recovery years prior to the year in which the basis is redetermined). Thus, the increase or decrease in basis shall be accounted for over the remaining recovery years beginning with the recovery year in which the basis is redetermined.

Expenditures that Create Intangible Assets or Benefits: Deductible or Capitalizable?

Reading:

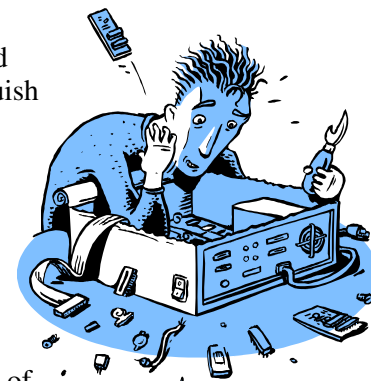
- *Indopco v. Commissioner*, 503 US 79 (1992)
- “Tangible Guidance On Intangibles – New Section 263 Regulations Provide Taxpayers With Certainty,” *Business Entities*, Fall 2004, Purcell and Nellen - to be posted to the Desire2Learn website

Deductible Repairs versus Capitalization

At January 2011, the IRS and Treasury continued to work on finalizing proposed regulations under §162 and §263 that provide more detailed guidance to distinguish repairs from capital expenditures.

Reg §1.162-4. Repairs

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept. [TD 6291 (4/3/58)]



Capitalization v Repairs Audit Technique Guide

[Below is the URL, table of contents and introduction to this guide. Go to the website for the full text. The Guide has a nice summary of numerous cases dealing with the issue of repair versus capitalization.

LB&I-4-0910-023 <http://www.irs.gov/businesses/article/0,,id=231440,00.html>

November 2010

This document is not an official pronouncement of the law or the position of the Service and cannot be used, or cited or relied upon as such.

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Appendix

1. Change in Method of Accounting
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6. Computer Audit Specialist Support

This Audit Techniques Guide (ATG) should be used as a tool, to assist examiners determine whether an expenditure should be capitalized or deducted. Whether an expenditure qualifies as a currently deductible repair, or is required to be capitalized is a factual determination. The burden of proof rests with the taxpayer, and sufficient contemporaneous records are required. To re-characterize previously capitalized expenditures as currently deductible repairs, taxpayers and their representatives will make a Change in Accounting Method (CAM) request. These CAM requests may go back many years, with taxpayers reviewing data from the 1990s and earlier to provide numbers for these changes. To justify a change in method, taxpayers will need to explain why they are changing their treatment of these expenditures. Examiners should consider the following steps when reviewing/examining this issue. Potential IDR questions have been developed to assist examiners in identifying the appropriate information to request from the taxpayer.

PLAINFIELD-UNION WATER CO., 39 TC 333 (1962) [footnotes omitted]

Respondent has determined a deficiency of \$16,471.61 in petitioner's income tax for the calendar year 1957. The only issue remaining before us is whether a certain expenditure made for cleaning and lining of pipe is a deductible repair or a capital expenditure.

FINDINGS OF FACT.

Some of the facts have been stipulated and are so found.

Petitioner, a New Jersey corporation incorporated in 1906, is a public utility engaged in the business of supplying water and, in connection therewith, maintaining a system of water mains and pipes used in conducting such supply of water to users in various towns in New Jersey. It filed its income tax return for the calendar year 1957 on an accrual basis with the district director of internal revenue at Newark, New Jersey.

Pipe was first installed in the Plainfield-Union water system in 1890. In 1910, petitioner installed 9,390 feet of 16-inch cast-iron pipe three-fourths of an inch in thickness (hereinafter sometimes referred to as the "Maple Avenue main") at a cost of \$18,804.54. At the time of the original installation of this pipe, it was painted internally with tar. Cement-lined pipe was not available in 1910. By December 31, 1957, petitioner had in its water supply system 2,825,624 feet of cast-iron pipe ranging in diameter from 2 to 24 inches, including 118,738 feet of 16-inch cast-iron pipe.

Petitioner has utilized the double declining balance method for depreciation purposes for all depreciable assets acquired after December 31, 1953. All of the assets in question are included in a single account. The composite rate of depreciation applicable is 3.5 percent.

Prior to utilization of the double declining balance method, petitioner had taken deductions on the straight line method at various composite rates. Until the close of the taxable year ending December 31, 1928, petitioner used various rates in the neighborhood of 2 percent. From January 1, 1929, through December 31, 1939, petitioner's composite rate was 2 1/4 percent. Since January 1, 1940, petitioner has utilized a composite rate of 1.75 percent for all depreciable assets acquired prior to December 31, 1953.

At the time of installation in 1910, the Maple Avenue main was assigned a useful life of 100 years. For Federal income tax purposes, this pipe had not been fully depreciated as of the end of the taxable year 1957.

Prior to 1950, petitioner used well water exclusively. In 1950, petitioner tied the Maple Avenue main into the Elizabethtown water system and thereby provided itself with an additional source of water. The Elizabethtown water herein relevant is filtered river water, which is substantially more "aggressive" (acidic) than the well water which otherwise comprised petitioner's system. Tuberculation results from the attack by an aggressive water upon the metal of a pipe beneath the tar or asphalt lining. This attack often occurs at points where the lining does not completely cover the metal. The aggressive water and metal produce an iron oxide which gradually pushes up the tar or asphalt coating, resulting in what is known as tuberculation. The result of tuberculation is that the carrying capacity of the pipe is often reduced, the maximum reduction usually being 50 percent. Red water and tuberculation frequently, but not always, occur together. Red water is often caused by a high velocity in the pipeline which carries some of the iron oxide deposits along the transmission main to the consumer.

The Elizabethtown system and petitioner were tied in at one end of the Maple Avenue main. At the other end there were two lines—the first comprised a 6,038-foot line of 16-inch tar-lined cast-iron pipe, installed in 1937, and the second consisted of a 16-inch cast-iron main running under Woodland Avenue. The connection between the Maple Avenue main and the latter line was closed, except for approximately 2 weeks, at all times material. Therefore no Elizabethtown water usually ran through it. The line under Woodland Avenue was not cement lined and had been installed by 1910. There had never been a drop in the carrying capacity of that line.

After passing through the Maple Avenue main and the 6,038-foot line, the Elizabethtown water continued into a 24-inch cement-lined Raritan Road main. The Raritan Road main, which was installed subsequent to 1950, was cement lined at installation. Petitioner has been buying solely cement-lined pipe since approximately 1954. By the time the Elizabethtown water reached the end of the Raritan main, it had mixed with well water and was comparatively diluted and nonaggressive.

Petitioner did not have any tuberculation prior to 1950. The Maple Avenue main lost carrying capacity sometime subsequent to the introduction in 1950 of the undiluted aggressive Elizabethtown river water and by 1954 there was a substantial diminution in said main's carrying capacity. Petitioner caused it to be cleaned, in 1954, in order to restore its carrying capacity to the pre-1950 level.

By 1957 the carrying capacity of the Maple Avenue main had again been substantially diminished and there was tuberculation in the relevant pipe. During the calendar years 1957 and 1958, petitioner caused the Maple Avenue main to be cleaned and lined with a cement lining three-sixteenths of an inch in thickness. During the calendar year 1957, 7,400 feet of said pipe was so cleaned and lined.

The cleaning and cement lining was commenced December 10, 1957, and completed January 8, 1958. The total contract cost was \$42,003.80, of which \$33,208 was allocable to 1957.

In 1960 petitioner caused the 6,038 feet of pipe between the Maple Avenue main and the Raritan Road main to be cleaned and cement lined. With the exception of the 1954 cleaning and the 1957-1958 and 1960 cleaning and cement lining, petitioner has never in its history cleaned or cement lined any of its formerly tar-lined pipe. The amount so cleaned and lined comprised approximately one-half of 1 percent of petitioner's pipes. There was no indication that further cleaning or cement lining would be needed by petitioner on any of its other lines.

The cement lining is not permanent and will wash out eventually. Cleaning and cement lining usually eliminate the problems of tuberculation and the necessity of periodic cleaning for as long as the cement lining lasts.

Of the \$33,208 allocable to the 1957 cleaning and cement lining of the Maple Avenue main, petitioner capitalized \$1,531.80 on its 1957 Federal income tax return and deducted \$28,355.40 as an ordinary and necessary business expense, which expense respondent has disallowed. Petitioner arrived at the capitalized figure of \$1,531.80 by applying a factor of 23 cents per foot to the 7,400 feet of pipe actually lined in 1957; 7,400 feet at 23 cents per foot gave a figure of \$1,702 against which the usual 10 percent retainage of \$170.20 was deducted, resulting in the net capitalized figure of \$1,531.80. Twenty-three

cents per foot represented the additional cost in 1957 for 16-inch cement-lined over tar-coated pipe three-fourths of an inch in thickness. The cost per foot, before installation, of cast-iron cement-lined pipe was \$6.43, and the cost per foot of pipe painted internally with tar was \$6.20.

The year 1957 was a base year for petitioner's regulated utility rate-making purposes. The accounting treatment employed by petitioner in connection with the relevant 1957 cleaning and cement lining for tax purposes was uniformly submitted to, and accepted by, the New Jersey Public Utilities Commission as a correct treatment. It would have been advantageous for petitioner to capitalize the relevant expenditures for rate-making purposes, because the rates are based on a percentage return of capital investment.

The reduction in carrying capacity of the Maple Avenue main during the 1950 through 1957 period was substantially caused by tuberculation resulting from the continued flow of aggressive Elizabethtown river water through said main.

The cleaning and cement lining of the Maple Avenue main was a repair which restored the original water carrying capacity of the pipes in question. Such pipe was previously and thereafter continued to be used in the normal course of petitioner's operations as a water company. The repair did not form a part of an overall plan of improvement. The cleaning and lining did not materially increase the useful life, value, or structural strength of the pipes involved, nor did it render those pipes suitable for any new or additional use by petitioner.

OPINION

The issue before us is whether the cost of cleaning and cement lining the Maple Avenue main during 1957 is a deductible repair under section 162(a)³ and the regulations thereunder, or whether it is a capital expenditure.

The area of repair or capital expenditure is replete with innumerable decisions which struggle unsuccessfully to draw a clear and useful line of general applicability. An expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair. A capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property.

As the Board stated in *Illinois Merchants Trust Co., Executor*, 4 B.T.A. 103, 106:

A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings. ***

The cost of keeping property "in an ordinarily efficient operating condition, may be deducted as an expense." Sec. 1.162-4, Income Tax Regs. If the repair does not "*materially* add to the value of the property nor appreciably prolong its life," it may be deducted as an expense.*Ibid.* (Emphasis supplied.) Petitioner asserts that the instant case comes within the purview of these criteria, and we agree.

Respondent contends that the value of the pipe to petitioner was materially increased by the expenditure and that it is, therefore, a capital expenditure. But any properly performed repair adds value as compared with the situation existing immediately prior to that repair. The proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure. Comparing the period before tuberculation and after expenditure, we see that the useful life of the Maple Avenue main was not increased by the cleaning and lining and that neither the strength nor the capacity of said main was enhanced.

Respondent is in error when he contends that the expenditure allowed petitioner to put the pipes to a new use. The main continued to be used in the normal course of petitioner's operations as a water company. It is true that water derived from rivers rather than water derived from wells was being used, but the substantial utilization of the pipes was the same, to wit, the conveyance of water to various homes.

Further, the river water could be, and was, used in the relevant pipes without cement lining. Periodic cleanings, clearly deductible ordinary expenses, would allow petitioner to use the Maple Avenue main at full capacity without cement linings. The cement lining was not a permanent addition to the pipe. By lining the pipes, petitioner merely eliminated, temporarily, a maintenance problem. That petitioner chose a less expensive, nonpermanent method of eliminating the tuberculation and restoring the capacity does not establish a new use.

Indeed, respondent has stipulated that the expenditure in question did not establish a new or additional use:

The cement lining of 16 inch cast iron pipe by petitioner in 1957 did not make the pipe suitable for any new or additional use by petitioner. Such pipe was previously and thereafter continued to be used in the normal course of petitioner's operations as a water company.

We hold that the expenditure in question did not result in a substantial new or additional use for the relevant pipes.

While an item which would otherwise be classified as a deductible repair may be held capital if it is part of an overall plan of general improvement, we hold that the relevant cleaning and cement lining comprised a very minor part of petitioner's operation and was not part of any general plan.

Respondent offers several cases which, in their factual context, hold that an expenditure should be capitalized. See, e.g., *Bonwit Teller & Co.*, 17 B.T.A. 1019, affirmed in part and reversed in part 53 F. 2d 381 (C.A. 2), certiorari denied 284 U.S. 690; *Teitelbaum v. Commissioner*, 294 F.2d 541 (C.A. 7), affirming a Memorandum Opinion of this Court, certiorari denied 368 U.S. 987; *Hotel Sulgrave, Inc.*, 21 T.C. 619.

We consider other cases, discussed immediately below, to be more in point.

In *Midland Empire Packing Co.*, 14 T.C. 635, the continued operation of a meat packing plant was threatened by oil seepage from a neighboring refinery into the cellar of the plant. Taxpayer lined the basement walls and floors with concrete to restore normal operating condition. We held that the expenditure was a deductible expense, since it did not increase useful life or value to taxpayer, did not provide for changed or enlarged use of the premises, and did not materially add value when compared with the pre-seepage period. We said at page 641: "The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used."

In *Illinois Merchants Trust Co., Executor, supra*, a lowering of the water level of a river exposed part of the wooden pilings upon which a building rested. Dry rot set in which threatened collapse of the building. Taxpayer sawed off the rotted parts and replaced them with concrete supports. The repair also entailed removal of a large part of the building's ground floor and the shoring up of a wall. The Board held the expenditure deductible.

In *Regenstein v. Edwards*, 121 F. Supp. 952 (M.D. Ga.), the floor of the third story of landlord's building sagged. After some temporary steps, steel columns and steel crossbeams were installed in order to permanently cure the defect. The court held that the entire expenditure was for the sole purpose of restoring the property to its former condition and allowed the deduction since neither use, value, nor life expectancy was increased.

In *American Bemberg Corporation*, 10 T.C. 361, affirmed per curiam 177 F. 2d 200 (C.A. 6), we held deductible an approximate \$900,000 expenditure for the drilling and filling of land which was undertaken to remedy an underground situation causing cave-ins under taxpayer's building.

In *Kansas City Southern Ry. Co. v. United States*, 112 F. Supp. 164 (Ct. Cl.), the taxpayer expended over \$116,000 to eliminate the effects of water pockets which had formed under portions of its railroad track. The elimination was accomplished by power-driving wooden poles vertically into the ground at the ends of the railroad ties, a process having beneficial effect for approximately 15 years. Failure to correct the water pocket effects would not have caused a shutdown of the line, but would have made operation at full capacity impossible. The court allowed the deduction and stated that (pp. 165-166):

[T]he railroad track, after the poles were driven, was still just a railroad track, and the parts of it where the poles were driven were no more useful than the other parts which had not needed this work.

See Rev. Rul. 54-356, 1954-2 C.B. 82, in which respondent agreed with this case.

Respondent argues that the need for an expenditure in the cases discussed above resulted from an unexpected happening or unusual circumstance. He asserts that the expenditure in the instant case was capital because the need for it arose from a management decision. We do not understand respondent to argue that the expenditure was not "ordinary" or "necessary" as used in section 162(a). We do not find that petitioner expected in 1950 that there would be a need for a cement lining. Indeed, in 1954 petitioner merely cleaned the relevant pipe, did not line it until 1957, and the tuberculation could have been removed by periodic cleaning.

We do not agree that the deduction in the instant case requires a relatively sudden, unexpected, or unusual external factor which results in casualty damage. In *Kansas City Southern Ry. Co. v. United States*, *supra*, a deduction was allowed for the elimination of water pockets under railroad tracks. The water pockets were not relatively sudden, unexpected, or unusual occurrences (Id. at p. 165):

Water pockets developed from time to time in the subgrade of the railroad track at various locations. *** If the nature of the soil is such that the water becomes trapped in the subgrade, the subgrade becomes and remains soft and yielding ***

In *J. II. Collingwood*, 20 T.C. 937, we allowed an ordinary business expense deduction for the cost of farm-land terracing. The need for the expenditure arose from a soil erosion situation which had been occurring for some time. We held that the purpose of the expenditure was to maintain the farm in an ordinary efficient condition. We allowed the deduction even though the soil erosion was not at all the unusual, unexpected, or sudden factor which respondent claims is requisite. See also *Farmers Creamery Co. of Fredericksburg, Va.*, 14 T.C. 879; *Buckland v. United States*, 66 F.Supp. 681 (D. Conn.).

We have given full consideration to the entire factual context of the instant case. The useful life, strength, value, and capacity of the cleaned and lined water pipes were not increased by the expenditure in issue. Said expenditure did not make the relevant water main suitable for any new or additional use. Said main continued to be used in the normal course of petitioner's operations as a water company. Viewing the record as a whole, we hold that the cleaning and cement lining of the Maple Avenue main in 1957 was a repair, the cost of which is deductible under section 162(a).

Decision will be entered under Rule 50.

FEDEX CORPORATION v. U.S., 92 AFTR 2d 2003-5986 (WD Tenn), aff'd 95 AFTR 2d 2005-1105 (6th Cir.) (minor editing for readability)

is a tax refund suit. It arises from a dispute about the tax treatment of FedEx's off-wing engine maintenance program during the 1993 and 1994 tax years. The Internal Revenue Service ("IRS") contends that FedEx's expenses related to that maintenance program are non-deductible capital expenditures under 26 U.S.C. § 263(a). FedEx argues that they are ordinary and necessary business expenses deductible under 26 U.S.C. § 162.

I. Subsidiary Findings of Fact

On February 15, 1994, FedEx timely filed Form 1120, United States Corporate Income Tax Return (“the 1993 Return”), for the taxable year that ended on May 31, 1993 (“TY 1993”). On February 15, 1995, FedEx timely filed Form 1120, United States Corporate Income Tax Return (“the 1994 Return”) for the taxable year that ended on May 31, 1994 (“TY 1994”). FedEx timely paid the full income tax shown according to the 1993 Return and the 1994 Return.

Upon review of the 1993 Return and the 1994 Return, the IRS, acting through its office in Memphis, Tennessee, issued reports proposing adjustments to the returns. Among the adjustments proposed were capitalization of engine shop visits (“ESVs”)² and of airframe heavy maintenance activity. These reports are referred to as the “30-Day Letters.” After FedEx protested certain adjustments proposed in the 30-Day Letters, FedEx and the IRS resolved most of the items at issue. FedEx and the IRS, however, did not resolve their dispute as to the proper Federal income tax treatment of ESVs during TY 1993 and TY 1994. In the 30-Day Letters, the IRS asserted that, if ESVs were given the proper tax treatment, FedEx would owe a combined additional \$37,428,624 in taxes for TY 1993 and TY 1994.

On August 11, 2000, FedEx paid the IRS \$70,000,000, the disputed amount plus interest, but maintained that FedEx's legal interpretation was correct and requested a refund. On January 4, 2001, the IRS informed FedEx of the IRS's intent to deny the refund request. On March 15, 2001, FedEx filed the instant action.

A. Treatment of Aircraft, Engines, and Auxiliary Power Units by FedEx and the Airline Industry

As part of its business, FedEx operated and continues to operate a fleet of aircraft. During TY 1993 and TY 1994 FedEx operated 205 and 202 aircraft, respectively. FedEx's aircraft included Boeing 727s (“727”), McDonnell Douglas DC-10s (“DC-10”), and McDonnell Douglas MD-11s (“MD-11”). Propulsion power for each FedEx 727, DC-10, and MD-11 was provided by three installed jet aircraft engines. During TY 1993 and TY 1994, Pratt & Whitney series JT8D engines were used to power FedEx 727s; General Electric (“GE”) CF6-6D model engines were used to power FedEx DC-10-10s; GE CF6-50C2 model engines were used to power FedEx DC-10-30s; and GE CF6-80C2D1F model engines were used to power FedEx MD-11s. During TY 1993 and TY 1994, auxiliary power for FedEx 727s was provided by GTCP85 series auxiliary power units (“APUs”) and auxiliary power for FedEx DC-10s and MD-11s was provided by TSCP700 series APUs.

Off-aircraft inspection, heavy maintenance, and repair of jet aircraft engines and APUs were conducted in almost all instances by third-party vendors during ESVs after removal of the engines or the APUs from the aircraft. FedEx's aircraft could not operate without three engines installed at all times. When FedEx removed one of the three engines from the wing to send it to an engine shop for an ESV, FedEx replaced the engine with another used FedEx engine that had returned from an ESV. Typically, only one of the three engines was removed at any given time, and an APU was not removed at the same time an engine removed.

Airframe heavy maintenance visits were generally scheduled based on flight hours or calendar time since the last heavy maintenance visit.

Aircraft engine ESVs, when “planned”, were sometimes based on engine use, measured in hours since last shop visit or cycles since last shop visit.³ These intervals were called “soft-time” thresholds and were based on FedEx's internal policies. Sometimes “planned” ESVs were scheduled because an engine had reached a “hard-time” threshold, meaning that immediate service was needed to comply with an FAA requirement that a life-limited part be replaced or with an FAA airworthiness directive that mandated disassembly. An unexpected condition, like foreign object damage, could precipitate an “unplanned” ESV.

When an engine reached a “hard-time” threshold, that engine became “unserviceable.” It had not become inoperable, but under FAA requirements, it was no longer “airworthy.” It could not be re-mounted to an

aircraft until the internal part that had reached its “hard-time” limit had been inspected and repaired if necessary, and an airworthiness certificate had been issued.

APU ESVs generally took place on an “on-condition” (as-needed) basis.

Airframe heavy maintenance visits could not be performed without the aircraft's being taken out of service. Engine and APU ESVs occasionally coincided with airframe heavy maintenance visits, but the engines and APUs could be removed and replaced without taking the aircraft out of service for a substantial period of time. Therefore, coordination was unnecessary. When FedEx's engines and APUs remained on-wing during airframe heavy maintenance visits, they were inspected, but did not usually undergo maintenance.

During TY 1993 and TY 1994, FedEx maintained separate written maintenance policies for engines and airframes. In developing policies for engines and airframes, FedEx was guided by the “Airline/Manufacturer Maintenance Program Development Document MSG-3, Revision 2” (“MSG-3”) and earlier versions of the same document. MSG-3 was developed by the Industry Steering Committee, a body of industry experts who shared expertise and developed policies that they recommended to members of the aircraft industry like FedEx. MSG-3 established inspection and maintenance standards for both on-aircraft and off-aircraft maintenance activities for all components of an aircraft.

Heavy maintenance of FedEx airframes, engines, and APUs was planned and coordinated by the base maintenance group. Within the base maintenance group, the propulsion maintenance group coordinated ESVs, and the airframe vendor maintenance group coordinated the heavy maintenance of airframes.

Under 14 C.F.R. § 1.1 of the Federal Aviation Regulations (“FARs”), an “Airplane” was an “engine-driven fixed-wing aircraft heavier than air, that is supported in flight by the dynamic reaction of the air against its wings.” Airplanes operated by FedEx could not fly without mounted serviceable jet aircraft engines.

Virtually all jet aircraft engines and APUs operated by FedEx in TY 1993 and TY 1994 were acquired or leased by FedEx as installed components of completely assembled aircraft or as spares in connection with the acquisition of completely assembled aircraft. In TY 1993 and TY 1994, FedEx acquired only a small number of jet aircraft engines or APUs in stand-alone purchases. FedEx never purchased airframes separately; it purchased only airframes that were parts of completely assembled aircraft.

Stand-alone engine and APU transactions occurred during TY 1993 and TY 1994. (Tr. Brasie 4/29 at 195.) Such transactions, however, were ad hoc and were not significant sources of engines or APUs for major carriers like FedEx. Demand for stand-alone used engines was low because carriers acquired spare engines and APUs when they acquired aircraft to ensure that they had a consistent stock of compatible engines and APUs. (Cukor Tr. 4/24 at 754.)

During TY 1993 and TY 1994, none of the major airframe manufacturers also manufactured jet aircraft engines. The major engine manufacturers aggressively marketed their engines to air carriers during this period, providing incentives directly to the carriers to persuade them to equip their fleets with the manufacturers' engines. FedEx purchased new engines and APUs directly from the original manufacturers.

FedEx timed its purchase of new engines and APUs to coincide with fleet purchases of new completely-assembled aircraft and required the engine manufacturer to install the engines on the airframes so that the airframes manufacturer could deliver the required completely-assembled aircraft to FedEx. When FedEx made a fleet purchase of used completely-assembled aircraft from another air carrier (often a passenger carrier), it also purchased spare engines and APUs because the selling air carrier would similarly have acquired spares at the time it acquired the aircraft. When a given model aircraft is retired, the engines that powered that model become obsolete.

Jet aircraft engines and APUs can be appraised separately from completely-assembled aircraft. The vast majority of such appraisals during TY 1993 and TY 1994, however, were performed in conjunction with

“full appraisals”—the appraisals of completely- assembled aircraft—rather than isolated appraisals of aircraft components. FedEx did not perform stand- alone appraisals of jet aircraft engines or APUs.

For financial accounting and tax purposes in TY 1993 and TY 1994, FedEx maintained separate accounts on its books for each type of airframe and engine in its fleet. For purposes of FedEx's accounts, an airframe included all portions of the aircraft (including the installed APU) other than the engines. FedEx's allocations of used aircraft purchase prices between the engines and the remainder of the aircraft were made solely by members of FedEx's Accounting Department, none of whom was an expert in engine or aircraft valuation. The allocations had no impact on FedEx's income for book or tax purposes and little time was spent making these allocations.

The International Society of Transport Aircraft Trading (“ISTAT”) defines the “economic useful life” of an aircraft or aircraft engine as “the period of time over which it is (or is expected to be) physically and economically feasible to operate it in its intended role. Periodic maintenance and repair will usually be required to preserve safety and efficiency during the economic useful life.” ISTAT defines “maintenance” as “actions required for restoring or maintaining an item in serviceable condition, including ... overhaul.” An ESV is an “overhaul” under the ISTAT definition.

The economic useful life of the airframes and aircraft operated by FedEx during TY 1993 and TY 1994 exceeded thirty (30) years. To attain this expected useful life, airframes had to undergo periodic maintenance and repairs, including heavy maintenance. FedEx expected its jet aircraft engines and APUs to perform for the entire useful life of the aircraft they powered: in excess of thirty (30) years. To attain this expected useful life, FedEx's jet aircraft engines and APUs had to undergo periodic on-wing and off-wing maintenance, including ESVs.

B. ESV Activities

During TY 1993 and TY 1994, the average interval between successive ESVs for an aircraft engine was approximately 24 to 36 months for FedEx's CF6 engines and 48 to 60 months for FedEx's JT8D engines.

ESVs included some or all of the following activities: disassembly, cleaning, inspection, repair, replacement, reassembly, and testing. ESVs are integrated processes: the later steps are dependent on the performance of the earlier steps. In the ESVs at issue in this case, the engine or APU was removed from the aircraft by FedEx and shipped to an outside vendor who performed the ESV. After removing an engine or APU, FedEx assessed the condition of the engine or APU and reviewed the work performed during previous ESVs to determine the level of maintenance an engine or APU was likely to require. This assessment resulted in a preliminary plan of maintenance, called the “workscope,” that FedEx provided to the vendor.

When the engine or APU arrived at the vendor, it was cleaned and externally inspected. (Tr. Mathieson 4/23 at 646.) Regardless of condition, it was thoroughly inspected visually and, as appropriate, further inspected using a number of non-destructive testing procedures. The workscope was often modified at the engine shop when the initial cleaning and inspection revealed defects that had not been detected at FedEx.

The engine or APU was then disassembled into major parts or “modules.”⁵ In some cases, the modules were further disassembled into piece parts. If inspection or testing had disclosed a discrepancy in a part's conformity to the specifications set forth in FedEx's Engine Inspection and Maintenance program, the part was repaired, or if necessary, replaced with a new or used serviceable part conforming to the specifications. Engine and APU parts were repaired if: (i) repair was feasible, (ii) repair was the lowest cost alternative to bring the part into conformity with specifications, and (iii) repair was permitted by FedEx's Powerplant Specification Manual.

ESV repairs were performed either by the vendor or by one of the vendor's subcontractors. Minor repairs included cleaning and restoring the surface finish of engine blades. An example of a more extensive repair would be restoring the tip of a blade by welding additional metal to the end. After necessary repairs and replacements were completed, the engine or APU was reassembled, tested, and returned to FedEx with an FAA Form 337, titled “Major Repair or Alteration.”

C. Part Replacement in ESVs

If a part could be repaired, but could not be repaired in time to be returned to the engine or APU with which the part had arrived, the vendor would first attempt to replace the part with a similar part from “customer stock.” Typically, customer stock parts were used parts that had been replaced or exchanged and repaired at FedEx's cost during an earlier ESV, had been stored, and were now being returned to FedEx engines at no additional cost to FedEx. If a part were not available from customer stock, the part was “exchanged.” The exchange was with a used, serviceable part in the vendor's inventory, so that the vendor could timely complete the ESV. When a part was exchanged, the part was removed from the engine or APU, and FedEx was charged only for the cost of repairing the part plus an exchange fee.

Replacements from customer stock and exchanges were repairs, rather than replacements, because charges to FedEx for those parts were, at maximum, the cost of repair and exchange (invoiced at the time the part was removed from the engine or APU), and the original parts could have been repaired and returned to the engine or APU from which they were removed, but for time constraints.

A part was “replaced,” meaning FedEx was charged the market price for the part, only if the part removed from FedEx's engine or APU could not be repaired. To minimize the cost to FedEx, vendors replaced parts with used serviceable parts, when available, rather than with new parts.

FedEx was charged for the repairs performed on the parts of the engine or APU that were sent to the vendor. FedEx did not receive a final invoice for an ESV from the vendor until the vendor had completed repairs on all repairable parts of the engine or APU.

D. Relative Cost of ESVs

The cost of ESVs varied from ESV to ESV based on the scope of the maintenance performed and the model of engine or APU at issue. The costs at issue in this case are the ESV invoice costs.

Trial Exhibit 121 is a materially correct calculation of the average cost of FedEx's ESVs for the listed engine and APU models during TY 1993 and TY 1994. The average value of FedEx's aircraft during TY 1993 and TY 1994 is accurately represented by Table 10 of the expert report of ACI Aviation. Based on those two sets of data, APU ESV costs ranged between 0.2% and 0.8% of aircraft value, CF6 engine ESV costs ranged between 0.9% and 3.5% of aircraft value, and JT8D engine ESV costs ranged between 2.1% and 8.1% of aircraft value. The following chart summarizes these calculations:

Engine/APU Model	Aircraft Model	Average ESV Cost Half-Time Value	Average Aircraft Half-Time Value	ESV Cost as Percentage of Aircraft Half-Time Value
JT8D-7B	727-100	\$243,830	\$3,000,000	8.1%
JT8D-15	727-200	\$432,557	\$6,500,000	6.7%
JT8D-17	727-200	\$473,960	\$6,500,000	7.3%
JT8D-217	727-200REF	\$301,943	\$14,300,000	2.1%
CF6-6D	DC-10-10	\$710,709	\$20,500,000	3.5%
CF6-50C2	DC-10-30	\$1,080,123	\$37,000,000	2.9%
CF6-80C2	MD11	\$872,912	\$97,500,000	0.9%
GTCP85	727	\$51,574	\$8,400,000	0.6%

TSCP700	DC-10-10	\$160,613	\$20,500,000	0.8%

TSCP700	DC-10-30	\$160,613	\$37,000,000	0.4%

TSCP700	MD11	\$160,613	\$97,500,000	0.2%

E. Impact of ESVs on FedEx's Engines, APUs, and Aircraft

When an engine or an APU was removed for an ESV, its value in use to FedEx exceeded its “scrap” value (the value of its parts if the engine or APU were to cease operation). Although engines were scheduled to be removed at “soft time” thresholds, the engines were not “unserviceable” when they hit those thresholds, and an engine could continue to power an aircraft if the scheduled removal time were inconvenient. If a “hard-time” threshold had been reached, the engine had to be maintained without delay, regardless of the engine's operability, for the engine to be serviceable. In some cases “unserviceable” engine needed only minor repairs to become “serviceable.” Even those engines and APUs that were “inoperable” when they were removed had value in excess of “scrap” value because they were designed to be compatible with a given model of airframes owned by FedEx and had been maintained in accordance with FedEx's maintenance policies.

The ESVs at issue in this case did not restore any engine or APU to “like new” condition. Because engines and APUs, like all other components of the aircraft, are separately considered during a full appraisal, the value of FedEx's aircraft would have been affected by any increase or decrease in the value of the engines or APUs. The value of an engine or APU after a given ESV was less than or equal to its value after the previous ESV. The value of the aircraft after successive ESVs, therefore, either remained stable or declined.

During TY 1993 and TY 1994, FedEx capitalized certain ESVs that are not at issue in this case. FedEx capitalized ESVs performed on engines or APUs that had not yet been placed in service or had less than half of the cycles expected until their next ESV because those costs were incurred to put the engines or APUs into service. FedEx also capitalized an ESV during which a new feature, called a “hush kit,” was added to the engine.⁶

The ESVs at issue in this case did not adapt any engine or APU to a new or different use. The ESVs at issue in this case did not materially increase the value of FedEx's aircraft, engines, or APUs. The ESVs at issue in this case did not appreciably prolong the lives of FedEx's aircraft, engines or APUs, but merely maintained them in proper working order during their expected useful lives.

II. Analysis and Conclusions of Law

A. Applicable Legal Standard

26 U.S.C. § 162 allows taxpayers to deduct ordinary and necessary business expenses paid or incurred during the current taxable year. Treasury Regulation § 1.162-4 (the “Expense Regulation”), which implements 26 U.S.C. § 162, provides in pertinent part: “The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition, may be deducted as an expense.” Treasury Regulation § 1.263(a)-1(b) (the “Capitalization Regulation”), implementing 26 U.S.C. § 263, restates the same rule from the perspective of the Internal Revenue Code's capitalization requirements.⁷ It provides in pertinent part that items are capital expenditures if they “(1) ... add to the value, or substantially prolong the useful life, of property owned by the taxpayer ... or (2) ... adapt property to a new or different use.” Id. The Capitalization Regulation further provides that “amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures....” Id.

“The distinction between capital expenditures and ordinary and necessary business expenses evades easy description.” *Dominion Res., Inc. v. United States*, 219 F.3d 359, 370 (4th Cir. 2000) (citing *Jones v. Comm'r*, 242 F.2d 616, 620 (5th Cir. 1957)). “Some items are clearly capital and other items are clearly

expense, but between the two extremes a point is approached at which it is difficult to determine whether the expenditure is capital or an expense.” *Libby & Blouin, Ltd. v. Comm’r.*, 4 B.T.A. 910, 913 (B.T.A. 1926). Whether a business expense is capital is highly dependent on the particular circumstances of a given case and is ultimately a factual determination for the trial court. *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001); *Libby & Blouin, Ltd. v. Comm’r.*, 4 B.T.A. at 913.

B. Unit of Property

When, as in the case at bar, a repair is made to a discrete component part of a larger item of property, the court must determine whether to apply the Repair Regulations to the component part or to the larger item of property. Otherwise stated, the court must identify which “unit of property” is being “repaired” and whether the repair materially adds to the value or appreciably prolongs the life of that unit of property. In the case at bar, the United States suggests that an ESV is a repair of the engine or APU while FedEx contends that an ESV is a repair of the aircraft powered by the engine or APU. Although FedEx and the United States are both strictly correct, the court must identify which is the relevant unit of property under the law.

In *Ingram Indus., Inc. v. Commissioner*, No. 14175-98, 2000 Tax Ct. Memo LEXIS 381, at 1 (U.S. Tax Ct. Oct. 18, 2000), the court had to determine whether towboat engine maintenance could be deducted under the Repair Regulations. This required the court to determine first whether the towboat engine or the towboat was the appropriate unit of property. The court based its decision about whether a towboat engine should be treated separately from a towboat on its analysis of whether “as a matter of industry practice, the engines are purchased or treated separately from the tow boats.”

In *Ingram*, the court noted first that “a towboat is a very large, integrated item of machinery comprised of a variety of components and systems” and that the “principal part is the propulsion system or engines and drive train.” Despite the significance of the engines, however, the court determined that, in the towboat industry, engines are not separately appraised and do not have an effect on the market value of the towboat as long as the engines “are operating and are said to have been well maintained.”

The court found that periodic, significant towboat maintenance generally occurs after the engines have driven the towboat for 25,000 to 35,000 hours—approximately every three to four years. So long as that maintenance occurs, the court found that a “towboat’s engines can continue operating safely, efficiently and profitably as part of a towboat’s main propulsion system for up to 40 years.” The engine maintenance at issue in *Ingram* could be performed without the engines’ being removed or the towboat being placed in dry dock.

The court held that the life of the towboat and the lives of its engines were forty years. Although the engines could only attain this life by undergoing significant, periodic maintenance, the intent that the engines last the life of the towboat was nonetheless manifest because the engines were acquired with the towboat (“albeit to the buyer’s specifications”), they could be maintained without removal from the boat, and the owners did not replace the engines “regularly and periodically” over the towboat’s life.

The unit of property issue was also a factor in *Smith v. Commissioner*, 300 F.3d 1023, 1030 (9th Cir. 2002). *Smith* involved the deductibility of the taxpayer’s process of relining its aluminum-producing cells as part of the taxpayer’s aluminum production operation. The taxpayer’s operation employed 650 cells. *Id.* The cells were spaced 24 to 28 inches apart from each other and were connected by busbars, which allowed the cells to share the same electrical current. On average, eight to ten cells were removed at a given time for relining. The smelting operation could continue with missing cells because the cells were arranged so that the electrical current could bypass a particular cell when necessary. The taxpayer required a minimum of 112 functioning cells to operate its system on a sustained basis.

The court held that a given cell, and not the entire cell line, was the appropriate unit of property. In reaching this conclusion, the court found that resolution of the unit of property issue turned on “whether the realities of [the taxpayer’s] smelting operations justify viewing the cells as independent units or constituent parts of a larger whole.”

In *Smith*, the only “reality” that the court explicitly identified was that the individual cell was capable of producing aluminum if it was not connected to a cell line. The trial court had concluded that, although the taxpayer had not set up its line to make this possible, the individual cell had the capability of producing aluminum and was sufficiently free-standing to constitute a separate unit of property. *Id.* In doing so, the court not only rejected the cell line as the unit of property, but also rejected the assertion that the cell lining was the relevant unit of property, presumably because the cell lining was not capable of producing aluminum without the cell.

Neither the tax Court, nor the Ninth Circuit (applying a “clearly erroneous” standard of review), explicitly detailed all of the factors leading to the conclusion that the individual cells were “free-standing.” On the facts the Ninth Circuit identified, however, it is clear not only that the individual cells could perform their function without the cell line, but also that the cell line could perform its function with a substantial number of missing cells.

Taken together, *Ingram* and *Smith* indicate the factors a court should consider in identifying the appropriate unit of property to which to apply the Repair Regulations. First, the court should consider whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management, or accounting purposes. Second, the court should determine whether the economic useful life of the component part is coextensive with the economic useful life of the larger unit of property. Third, the court should determine whether the larger unit of property and the smaller unit of property can function without each other. Finally, the court should weigh whether the component part can be and is maintained while affixed to the larger unit of property.

Applying the first factor to the case at bar, the court should consider, as a matter of taxpayer or industry practice, whether the engines and APUs are purchased or treated separately from the aircraft. In *Ingram*, an engine was not considered to have been purchased separately from the vehicle it powers merely because it was separately ordered.

In TY 1993 and TY 1994, The Federal Aviation Administration provided that engines and airframes combined to form a single unit of property. Although the FARs separately defined “airframes” and “aircraft engines,” the definition of “airplane” included the airframe (referred to wings) and explicitly referred to the engines. FedEx flew airplanes, not airframes or engines, and thus the definition of an “airplane” is the relevant definition to consider.

Based on the evidence presented at trial, FedEx and other major air carriers considered engines to be part of an aircraft during TY 1993 and TY 1994. Although engines and APUs may be appraised separately, the overwhelming majority of the appraisals performed during and around the period at issue were full appraisals, including engines and APUs as part of the aircraft.

Stand-alone sales of engines and APUs rarely occurred during TY 1993 and TY 1994. Although new engines and APUs were separately manufactured and sold separately from new airframes, the engines and APUs were designed to be compatible with certain airframes, were acquired at the same time as those airframes, and were delivered to FedEx either as part of the completely assembled aircraft or as spares to fit the specific airframe type being acquired.⁸ This acquisition pattern of new engines also translated into infrequent stand-alone sales of used engines and APUs. Because an air carrier acquired a full stock of compatible engines and APUs, as well as other spare parts, when it acquired a given aircraft, the carrier did not need to acquire additional used engines. Likewise, when an air carrier sold a fleet of aircraft, that sale included the engines, APUs, and other spares because the seller no longer had aircraft with which those components would be compatible.

There are distinctions in how FedEx airframes and engines/APUs were maintained, but those distinctions are not so striking as to justify treatment of engines and APUs as units of property separate from the aircraft. Engines/APUs and airframes were governed by different maintenance policies, sent to different vendors, and maintained on different schedules. Although relevant, the significance of these distinctions should not be overstated. The different types of engines and APUs were not handled uniformly either, but were governed by different maintenance policies, sent to different vendors, and maintained on different

schedules from one other. Despite differences in maintenance policies and procedures, all parts of the aircraft, including airframes, engines, and APUs, were ultimately governed by a single department (base maintenance) and guided by a unified maintenance plan (MSG-3).

For accounting purposes, FedEx separately allocated for engines (although it did not do so for APUs). These allocations were not made based on true valuations and had no impact on FedEx's income for book or tax purposes. This evidence suggests only that the FedEx accounting department found it convenient to book engines separately from airframes, APUs, and other parts of the aircraft and is not sufficiently significant to justify treating aircraft engines separately from the rest of the aircraft.

Based on the foregoing, the substantial weight of the evidence establishes that engines and APUs were treated as part of fully-assembled aircraft for purposes of acquisition, operation, maintenance and disposal. This factor, taxpayer and industry treatment of the property, favors classifying the aircraft as the unit of property for applying the Repair Regulations.

The second factor to consider is whether the expected useful life of an engine or APU, if properly maintained, is co-extensive with the aircraft. Under the Ingram approach, if an engine is not “regularly and periodically” replaced over the life of the aircraft, then the useful life of the engine is coextensive with the life of the property that it powers.

The lives of the engines and APUs at issue here were co-extensive with the airframes on which they were mounted. Although the engines and APUs required regular on-wing inspection and maintenance, as well as periodic ESVs, FedEx expected all of their main components to last thirty years.⁹ There is no evidence that FedEx participated in the stand-alone engine “market” on more than a rare basis. FedEx did not regularly or periodically replace its engines. FedEx continued to use the engines and APUs it purchased at the time it purchased its aircraft to power those aircraft throughout their useful lives.

The third factor to consider is whether the larger unit of property and the smaller unit of property can function without each other.¹⁰ A tugboat cannot tow barges without its engines, and the engines cannot tow barges without a tugboat. In contrast, the design of the cell line in Smith allowed the operation to produce aluminum as long as 112 of 650 cells were installed, and a given cell could produce aluminum without being attached to a cell line. Engines and APUs cannot perform their function of powering jet aircraft unless they are mounted on those aircraft in proper working order. Aircraft cannot fly without engines and APUs.

Finally, the court must consider whether the smaller unit of property must be removed from the larger unit of property for maintenance to occur. In Ingram, the court concluded that the tugboat was the unit of property in part because the tugboat engines were maintained while attached to the tugboat. The Smith court, in reaching the opposite unit of property conclusion, noted that the maintenance of the cell required its removal from the cell line.

In the context of the case at hand, this factor only slightly favors treating the engines and APUs as separate units of property from the airframes. When maintenance was performed on the tugboat engines in Ingram, the entire vessel was rendered inoperable. In the case of jet aircraft, in which the engines (and certainly APUs) are a comparatively less significant part of the whole, one of the three engines can be removed, switched with another engine, and sent for an ESV, allowing the aircraft to remain in service while the engine is serviced.

The court notes, however, that there is an important difference between the cells in Smith and the engines and APUs in the case at bar: in Smith, large numbers of cells could be removed without interfering with the functioning of the cell line. FedEx airplanes, in contrast, require an APU and three working engines to remain in service at all times. In addition, the cells in Smith could individually produce aluminum—aircraft engines and APUs separate from the aircraft cannot accomplish their purposes. Although removal indicates that jet aircraft engines and APUs are comparatively more distinct from aircraft than tugboat engines are from tugboats, this factor does not so strongly weigh in favor of an engine's being treated as a separate unit of property that it counterbalances what the other factors indicate: engines and APUs are

integrally linked to the aircraft that they power and the aircraft should be considered a single unit of property.¹¹

C. ESVs as “Incidental Repairs”

The Repair Regulations allow taxpayers to deduct the cost of “incidental repairs” which do not (1) materially add to the value of the property, (2) appreciably prolong the life of the property, or (3) adapt the property to a new or different use. The United States suggests that the adjective “incidental” creates an independent test of magnitude under which a court could find that an item must be capitalized, separate from the addition of value, the prolongation of life, or the adaptation to a new use. This contention is not supported by the case law.

The United States cites four cases in which it contends courts determined that costs were not deductible because the cost of the repairs was so high relative to the cost of acquisition or the value of the item that the repairs could not be treated as “incidental.” Thus, those non-incidental repairs would not be deductible. Although the courts in the cases cited consider the relatively high cost of the repairs at issue, they do not create a separate “incidental” test.

In two of the cases cited by the United States, the courts' holdings were based on a finding that the taxpayer had adapted the property to a new use. In *Dominion Resources, Inc. v. United States*, 219 F.3d 359, 370 (4th Cir. 2000), the court held that, after taxpayer had acquired the property, it had incurred substantial environmental cleanup costs “to “put” the property into a new condition rather than to “keep” the property in its ordinary efficient condition” and that expenses incurred to “put” property into a new condition must be capitalized. Although the court found that the high cost of the expenditure further supported its finding that the improvements to the property were substantial, the court also noted that the inquiry must focus not on the value of the improvement but on the “nature” of the improvement.

Likewise, in *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510, 519 (6th Cir. 2001), the court noted the substantial relative costs of the expenditures as compared with the acquisition cost of the land and contrasted those costs with the relatively lower costs allowed as deductions in *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 334 (1962). The court's holding, however, did not depend on a magnitude test or the term “incidental.” Rather, the court held that Plainfield-Union did not apply “when a taxpayer has improved defects that were present when the taxpayer acquired the property.” *United Dairy Farmers*, 267 F.3d at 518–19. Although the expenditures in *United Dairy Farmers* were also different in magnitude, the key difference from the court's perspective was that the expenditures were different in kind—they were incurred to “put” the property in a new condition rather than “keep” it in a given condition. *Id.*

In *Smith v. Commissioner*, 300 F.3d 1023, 1030 (9th Cir. 2002), the court, again holding that the expenditure was capital in nature, noted the substantial relative cost of the expenditure. The court's decision, however, was based primarily on its finding that the cell lining replacement substantially prolonged the cell's life and only secondarily on its finding that the tax court did not err by failing to conclude that the relining expenses did not materially increase the value of the cells. *Id.* at 1033–34. Under the Repair Regulations, the court's finding on the prolongation of life issue would alone have been sufficient to require capitalization. The United States is correct that the *Smith* court found that the cell relining costs were not “incidental,” but nothing in *Smith* establishes “incidental” as an independent hurdle or defines “incidental” in terms of the relative costs incurred.¹²

The court finds no support for treating “incidental” as a separate capitalization requirement under the Repair Regulations. High cost of repairs relative to acquisition cost or value may be a useful indicator that one of the established capitalization requirements has been met. See, e.g., *LaSalle Trucking Co. v. Comm'r*, No. 94987, 1963 Tax Ct. Memo LEXIS 68 (U.S. Tax Ct. Oct. 7, 1963) (holding that the high cost of replacing substantial components of a truck relative to the truck's acquisition cost made it “difficult to believe that the life of a truck was not extended and its value not increased by the [expenditures].”). “Incidental” is not logically read, however, as an independent requirement, but as a

description of those improvements that do not increase the value of a specified unit of property, prolong its useful life, or adapt it to a new use.¹³

D. The Plainfield-Union Test

Engine and APU ESV costs should have been capitalized if they materially added to the value of FedEx's aircraft, appreciably prolonged their life, or adapted them to a new or different use. The United States claims that the court should make this determination by comparing the state of an engine or APU immediately preceding an ESV with the state of that engine or APU immediately following (“fresh” from) that ESV.¹⁴ FedEx contends that the court should follow the test articulated in *Plainfield- Union Water Co. v. Commissioner*, 39 T.C. at 334, under which the court would compare the state of the engine or APU fresh from one ESV with its state fresh from its next ESV.

Under the Plainfield-Union test, “[a]n expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair.” 39 T.C. at 337. By a “situation prompting the expenditure,” the court refers both to conditions that normally occurred over a period of time, like soil erosion, as well as “relatively sudden, unexpected, or unusual occurrences,” like oil seepage. The court considers a capital expenditure “to be a more permanent increment in the longevity, utility, or worth of the property” rather than an expenditure intended to correct a “situation.”

The United States, citing *Smith v. Commissioner*, argues that application of the Plainfield-Union test (comparing the condition prior to deterioration and the condition after repair or replacement) in all capitalization cases “would permit deductions under § 162(a) for any repair expense, no matter how substantial, since it would always be the case that replacement simply restored the machine to its previous working condition.” 300 F.3d at 1034. *Smith*, however, also criticizes the test urged by the United States as invariably requiring that expenditures be capitalized.

Smith does not challenge Plainfield- Union generally, but rather, consistent with the fact-specific nature of the capitalization inquiry, *Smith* highlights a situation to which the Plainfield-Union approach is ill-suited: the replacement of an essential functional component of the property. The key lesson of *Smith* is that the condition of the property at the time of the expenditure remains relevant. In *Smith*, the court concluded first that the lining had no functional life remaining at the time the cell was relined. The court then concluded that the cell lining was so critical a component of a cell that “its replacement is tantamount to reconstituting the cell itself.” *Smith* adopted an “essential component” rule to be applied when an essential component of the property is replaced.

Application of the *Smith* “essential component” rule is not justified by the facts of this case.

Unlike the cells in *Smith*, FedEx engines and APUs were not functionally exhausted at the time the engines and APUs were removed for ESVs. When they were removed from the wing, they were often serviceable. Those engines and APUs that were not “serviceable” because they required inspection and cleaning under FAA regulations could often be rendered serviceable by minor repairs.

ESVs are more properly classified as repairs, rather than as replacements of essential components of an aircraft. Although essential to an aircraft's functioning, engines and APUs are far less significant than the cell linings in *Smith*, which comprised the entire functioning component of the cell. An aircraft has numerous working parts whose functioning is unrelated to the functioning of the engines and APUs. Engines and APUs are not “essential components” as the term was used in *Smith* because their replacement would not be “tantamount to reconstituting the [airplane] itself.”

Smith's essential component rule, furthermore, applies only to the replacement of the “essential component.” At trial, the United States suggested that the level of part replacement was such that in many ESVs the engine or APU was essentially “replaced.” The evidence does not support this contention. In ESVs, most of the parts required only inspection and cleaning or inspection, cleaning, and repair. Although some ESVs involved a substantial number of replacement parts from customer stock or through exchanges of parts, those activities were not true replacements because the parts were repaired and

returned to a compatible engine or APU during a later ESV. They could have been returned to the engine or APU from which they were removed but for the vendor's need to meet its deadline. FedEx's invoices appropriately treated these costs as repairs, and the invoice costs are what is at issue in this case.

The court finds the Plainfield-Union test to be the appropriate measure of the impact of ESVs on the state of FedEx's aircraft and will apply that test to the facts of this case.¹⁵ In so doing, the court is not departing from the fact-specific nature of its inquiry. The court's duty is to determine whether ESVs are property-enhancing capital expenditures or business expenses incidental to the maintenance of FedEx's aircraft. The need for ESVs was prompted by FedEx's use of its aircraft in transporting packages. As a consequence of powering the aircraft, parts of the aircraft's engines and APU were damaged by general use and by the high temperatures to which their parts were exposed. The Plainfield- Union test is most appropriate because the relevant facts of that case are closely analogous. Like the case at bar, Plainfield-Union involved similar maintenance (repair rather than replacement) necessitated by a similar condition (damage necessarily sustained in the ordinary course of using the property).

To determine whether the ESVs materially added to the value of FedEx's aircraft, appreciably prolonged their life, or adapted them to a new or different use, the court compares the state of the engines and APUs before the "condition" necessitating an ESV to the state of the engines and APUs "fresh" from an ESV. The "condition" necessitating the ESV was the wear and tear an engine or APU had sustained in powering FedEx's aircraft since a previous ESV. Under this analysis, if an engine or APU is in no better condition after a given ESV than it was after the preceding ESV, the ESV could not have improved the condition of the aircraft, and the court must conclude that the ESV only corrected the damage sustained by the aircraft during the ordinary course of its operation.

The United States concedes that the ESVs at issue in this case did not adapt the engines or APUs to a new or different use. Because ESVs did not affect the functioning of FedEx's aircraft separately from their effect on the functioning of the aircraft's engines and APUs, this concession also applies to the impact of ESVs on the aircraft. The court, therefore, need only consider the other two components of the Repair Regulations: the impact of ESVs on aircraft value and the impact of ESVs on aircraft life.

If an ESV materially added to the value or appreciably prolonged the life of FedEx's aircraft as compared with the condition of the aircraft immediately following the preceding ESV, the ESV costs should have been capitalized.

ESVs did not materially increase the value of FedEx's aircraft. Although the United States challenged FedEx expert Quentin Brasie's testimony that engine and APU values declined over time, the United State's contrary assertion was only that engine and APU values remained relatively flat over time. An engine or APU fresh from an ESV was not worth more than it had been worth immediately following its previous ESV. Because the ESV did not increase the value of the engine or APU, it did not increase the value of the aircraft.

The ESVs at issue in this case did not appreciably prolong the life of FedEx's aircraft. FedEx acquired its airframes, engines, and APUs with the expectation that they would last over thirty years. FedEx designed its maintenance programs to keep airframes, engines, and APUs in working order throughout their useful lives. The United States has urged the court to find that the ESVs conferred new life on FedEx's engines and APUs, thus prolonging the life of FedEx's aircraft. The United States has supported this contention principally by arguing that the term "half-life" was often used to refer to the time half- way between ESVs. The proof demonstrates, however, that "half-life" in that context referred only to engine maintenance status.

The court in this case is concerned with the economic useful life of FedEx's aircraft, a term precisely defined by ISTAT as: "the period of time over which it is (or is expected to be) physically and economically feasible to operate [aircraft, engines, and APUs] in their intended role. Periodic maintenance and repair will usually be required to preserve safety and efficiency during the economic useful life." FedEx treated each aircraft as a unit. ESVs maintained FedEx's engines and APUs so that

they, as part of the aircraft that they powered, could continue to operate for the period of time FedEx had intended. ESVs preserved, but did not prolong, the useful economic life of FedEx's aircraft.

IV. Conclusion and Ultimate Findings of Fact

- (1) During TY 1993 and TY 1994, FedEx's engines and APUs were so closely linked to the aircraft on which they were mounted that they were part of a single unit of property, the aircraft, for purposes of the Repair Regulations.
- (2) During TY 1993 and TY 1994, the ESV invoice costs at issue in this case were incurred as ordinary and necessary business expenses incidental to the maintenance of FedEx's aircraft, engines, and APUs and were properly deductible under 26 U.S.C. § 162 and the Repair Regulations.

V. Issue Remaining for Phase II

Because the court has concluded that ESV costs incurred by FedEx during TY 1993 and TY 1994 were deductible in full, only one issue remains for Phase II of the trial: the magnitude of the section 481 Adjustment. FedEx and the United States have agreed that evidence pertaining to the section 481 Adjustment would be reserved for Phase II of the trial. The parties further stipulated that, were the court to conclude that the ESV costs at issue were fully deductible, as it now has ruled, the section 481 Adjustment should be set aside in full. The parties, however, have not yet agreed on the correct formula for calculating the section 481 Adjustment. Therefore, should the parties be unable to agree on a formula, the court will, after appropriate Rule 26 disclosures and discovery, conduct Phase II of the trial to resolve this issue.

²

“ESV” stands for engine shop visit. ESVs refer to periodic “off-wing” maintenance performed on engines and APUs by specialized vendors known as engine shops. Except where the court explicitly states otherwise, the court's reference to ESVs refers only to the ESVs at issue in this case—those whose cost FedEx seeks to deduct as business expenses.

³

A cycle is one take-off and one landing.

⁴

Documents referred to by “FX” bates numbers come from 21 CD ROM disks entered into evidence as Exhibits 1-21, provided separately and installed as a group on a laptop computer by consent of the parties.

⁵

The original equipment manufacturers designed engines and APUs to disassemble into modules to facilitate their maintenance. Each module was independently assessed by FedEx and prescribed a level of maintenance in the workscope. Modules for a given model engine were interchangeable so that a module would occasionally be removed from one engine and installed on a different engine. The CF6 engine was comprised of five modules: the high pressure compressor, the combustor, the high pressure turbine, the low pressure turbine, and the gearbox. The JT8D engine was comprised of six modules: the low compressor, the high compressor, the diffuser and burn module, the HPT module, the LPT module, and the exhaust module. An APU was comprised of two modules: the power section and the gearbox.

⁶

“Hush kits” made the engines quieter, and their installation was mandated by the FAA.

⁷

The court refers to Treasury Regulation § 1.162-4 and Treasury Regulation § 1.263(a)-1(b) collectively as the “Repair Regulations.”

⁸

A completely assembled aircraft was always delivered to FedEx. Any spares are in addition to the engines and APU mounted on a given aircraft at the time of delivery.

[9](#)

The United States contends that the economic useful life of a FedEx engine or APU was the period between ESVs. In support of this claim, the United States argues that the level of part replacement in ESVs was such that the ESVs conferred a new life on the engines and APUs. This contention, however, is based on a false conception of the level of “new” parts replaced during ESVs. The United States did not consider properly the substantial number of installed parts that were not “new,” but came from other FedEx engines and would have been reinstalled in those engines but for the need for engine shops to meet FedEx's deadline (known as the “turn time”) for return of an engine or APU. The United States emphasized the testimony of FedEx's expert, Quentin Brasie, who had referred to the time half-way between ESVs as the “half-life” of the engine. The record reflects, however, that “life” used in that context does not refer to the economic useful life of the engine and that any attempt to use the term “half-life” in that context would be inaccurate. Rather, the term “economic useful life” has been precisely defined by ISTAT, the primary appraisal authority in the airline industry, and that definition contemplates periodic ESVs during the useful lives of aircraft, engines, and APUs.

[10](#)

This factor is similar to the “functional interdependence test” that FedEx has urged the court to adopt. That test, developed in a different context, comes from Treasury Reg. § 1.263A-10(c), and provides that components of property should be treated as a single unit if they are “functionally interdependent.” Two items are “functionally interdependent” if “the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person.” *Id.* The court declines to adopt the “functional interdependence test” as an absolute test for determining the appropriate unit of property. As Ingram and Smith make clear, however, functional interdependence is one important factor in determining which unit of property to use in applying the Repair Regulations.

[11](#)

Removability is less significant in determining whether a given component of an aircraft should be deemed a separate unit of property because aircraft are modularized. Smaller components, like landing gear, are also removed for off-aircraft maintenance.

[12](#)

As the United States acknowledges, the last case it cited, *Louisville & Nashville R.R. Co.*, 641 F.2d 435 (6th Cir. 1981), does not involve the Repair Regulations.

[13](#)

Even if the court were to assume that expenditures must be capitalized if maintenance costs are found to be high in comparison with the value of the property, the record shows that ESV costs are not high relative to the value of the aircraft, ranging from only 0.3% for the TSCP700 APU to 8.1% for the JT8D-7B engine.

[14](#)

The court has determined that the completely-assembled aircraft is the appropriate unit of property. The court has also found that ESVs do not affect the life or value of an aircraft in a manner different from the way ESVs affect the life or value of the engines and APUs. The court's decision on the unit of property issue does not preclude the court from doing what it must do to assess the effect of ESVs on the completely-assembled aircraft: examine the effect of ESVs on engines and APUs.

[15](#)

The United Dairy Farmers court notes that *Plainfield-Union* is poorly tailored to cases in which the taxpayer acquired the property in a deteriorated condition and incurred costs to “put” the property into service, rather than “keep” the property in service. In that situation, *Plainfield-Union* would fail to capture improvements. See *United Dairy Farmers*, 267 F. 3d at 518–19. The ESVs at issue in this case, however, involve only the costs of keeping the engines and APUs in service, and thus *United Dairy Farmers'* criticism of *Plainfield-Union* would not apply in this context. FedEx did capitalize the cost of ESVs necessary to place its engines and APUs into service.

FSA 200122002 (excerpt)

Depreciation of Tires and Tubes

This Field Service Advice responds to your memorandum received by this office on November 1, 2000, regarding the matter referenced above. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

ISSUES

1. Whether the cost of tires and tubes purchased for new vehicles must be capitalized and recovered through depreciation, or is such cost currently deductible as a business expense?
2. If the cost of the tires and tubes must be capitalized, are the tires and tubes treated as separate assets for depreciation purposes and, if so, over what recovery period are they depreciated?
3. If the cost of tires and tubes must be capitalized, and tires and tubes are treated as separate assets for depreciation purposes, how is the cost of replacement tires and tubes recovered?

CONCLUSIONS

1. If the factual development indicates that the tires and tubes at issue have a useful life of more than one year, the cost of the tires and tubes must be capitalized and recovered through depreciation. Otherwise the cost is currently deductible.
2. If the cost of the tires and tubes must be capitalized, the tires and tubes are treated as assets separate from the vehicles for depreciation purposes. The recovery period for the tires and tubes is 5 or 8 years.
3. If the cost of replacement tires and tubes must be capitalized, their cost is recovered in the same manner as the cost of new tires and tubes.

FACTS

Taxpayer has strict maintenance and operating procedures that enable the vehicles to remain in operation for 25 years or more. For each of the years at issue, Taxpayer purchased numerous new vehicles, most of them without tires. Taxpayer contracted separately with tire companies, purchased the tires in bulk, and arranged to have the tires placed on the vehicles.

Taxpayer is an accrual basis taxpayer. During the years at issue, Taxpayer deducted as a current operating expense the cost of the tires and tubes for its new vehicles in the month in which it capitalized the cost of the vehicles. Thereafter, Taxpayer deducted as a current operating expense the cost of replacement tires and tubes. Taxpayer's treatment of tires and tubes for new vehicles and replacement tires and tubes was consistent with its practice during previous years. Taxpayer contends that tires and tubes are rapidly consumable separate assets. The Service believes that its ongoing factual development will show that Taxpayer's tires and tubes last several years.

LAW AND ANALYSIS

Issues 1, 2, and 3

Section 162 of the Internal Revenue Code allows a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business. However, section 263(a) prohibits a deduction for capital expenditures. Capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. Section 1.263(a)-2(a) of the Income Tax Regulations. Such capital expenditures are subject to the allowance for depreciation.

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

The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in section 168(a) and the other method is the alternative depreciation system in section 168(g). Under either depreciation system the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of either section 168(a) or 168(g), the applicable recovery period is determined by reference to class life or by statute. Section 168(i)(1) provides that the term “class life” means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former section 167(m) as if it were in effect and the taxpayer were an elector. Prior to its revocation, section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) sets out the method for asset classification under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.

Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowances under section 168. The revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The same item of depreciable property can be described in both an asset category (that is, asset classes 00.11 through 00.4) and an activity category (that is, asset classes 01.1 through 80.0), in which case the item is classified in the asset category. See *Norwest Corporation & Subsidiaries v. Commissioner*, 111 T.C. 105 (1998) (item described in both an asset and an activity category (furniture and fixtures) should be placed in the asset category). The asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 00.241, Light General Purpose Trucks, includes trucks for use over the road that weigh less than 13,000 pounds. Trucks in this class have a recovery period of 5 years for purposes of both sections 168(a) and 168(g).

Asset class 00.26, Tractor Units for Use Over-The-Road, provides a 3-year recovery period for purposes of section 168(a) and a 4-year recovery period for purposes of section 168(g) for vehicles includible in this class.

Asset class 00.27, Trailers and Trailer-Mounted Containers, provides a 5-year recovery period for purposes of section 168(a) and a 6-year recovery period for purposes of section 168(g) for assets includible in this class.

Asset class 42.0, Motor Transport — Freight, includes assets used in the commercial and contract carrying of freight by road, except for transportation assets included in classes with the prefix 00.2. Assets in this class have a recovery period of 5 years for purposes of section 168(a) and 8 years for purposes of section 168(g).

Rev. Rul. 59-249, 1959-2 C.B. 55, holds that the cost of tires and tubes on new commercial trucking equipment purchased and used by the taxpayer in motor freight transportation is deductible in full as ordinary and necessary business expense in the taxable year of purchase if such tires and tubes are consumable within that year or their average useful life is less than one year even though it extends in part into the next year.

Rev. Rul. 68-134, 1968-1 C.B. 63, holds that the principles of Rev. Rul. 59-249 are applicable to tires in the case of a taxpayer who is a purchaser-lessor of new commercial trucking equipment.

Rev. Rul. 69-560, 1969-2 C.B. 25, holds that the cost of tires and tubes purchased by the taxpayer on new highway construction equipment that it uses or leases is deductible in full as ordinary and necessary business expense in the taxable year of purchase where such tires and tubes have an average useful life of less than one year.

Rev. Rul. 73-357, 1973-2 C.B. 40, holds that the cost properly allocable to tires and tubes on used construction equipment purchased by the taxpayer is deductible as an ordinary and necessary business expense in the taxable year of purchase if their average remaining useful life is less than one year.

The revenue rulings discussed above were issued in the context of several court cases that had addressed the treatment of the cost of tires and tubes purchased with vehicles and equipment. *W.H. Tompkins Co. v. Commissioner*, 47 B.T.A. 292 (1942); *Interstate Truck Service, Inc. v. Commissioner*, T.C. Memo. 1958-219; *Zelco, Inc. v. Commissioner*, 331 F.2d 418, 421 (1st Cir. 1964). In support of its conclusion that the cost of truck tires and tubes consumable within the taxable year purchased are currently deductible as business expense, the court in Tompkins noted that while it could not allow as an expense every part of a truck's mechanism that might wear out in less than a year, the tires and tubes are easily separable from the truck and are not a part of the truck's mechanism. The court thought it "absurd" to associate the short-lived tires' cost recovery with the depreciation of the much longer-lived trucks. In *Interstate* the court allowed the current deduction of the cost of tires and tubes even though not all of the tires and tubes at issue were consumable within the taxable year of purchase. However, the court found that on average all of the tires and tubes were consumable in less than one year. After discussing both of these cases, Rev. Rul. 59-249 announces that the Service will follow these decisions. Rev. Rul. 68-134 discusses the *Zelco* decision, noting that the appellate court concluded that a lessor of vehicles was not required to treat tires as a part of the leased vehicles.

The cases and revenue rulings discussed above stand for the proposition that tires and tubes are not treated as part of a vehicle for depreciation purposes. Rather, they are considered to be separate assets and, as such, their cost is currently deductible by a purchaser provided they are consumable in less than one year. It is of critical importance to note that in each of these cases and revenue rulings the tires and tubes at issue were consumable in less than a year. Accordingly, if the factual development shows that the tires and tubes at issue in the present case have an average useful life to Taxpayer of more than one year, their cost cannot be currently deducted by Taxpayer as an operating expense. Their cost must be capitalized and recovered through depreciation. For purposes of our continuing analysis, we will assume that the tires and tubes at issue have an average useful life of more than one year.

As stated previously, the preceding cases and revenue rulings conclude that tires and tubes are separate assets from the vehicles or equipment to which they are attached. Because they are not considered to be part of the vehicle for depreciation purposes, they are not associated with any of the specific transportation assets included in the asset classes of Rev. Proc. 87-56 with the prefix 00.2. Therefore, in accordance with section 168 and Rev. Proc. 87-57, tires and tubes that must be capitalized are depreciated as assets used in specific business activities. In the present case, Taxpayer's business activity is described in asset class 42.0, Motor Transport — Freight. Assets in this class have a recovery period of 5 years for purposes of section 168(a), and 8 years for purposes of section 168(g).

The preceding analysis is equally applicable to Taxpayer's replacement tires and tubes. If Taxpayer's replacement tires and tubes have an average useful life to Taxpayer of more than one year, their cost must be capitalized and recovered through depreciation. As discussed above, tires and tubes are treated as assets separate from the vehicles for depreciation purposes. Because, under section 168, all of Taxpayer's tires and tubes, whether original or replacement, would be depreciated as assets used in Taxpayer's motor transport- freight business activity (asset class 42.0), Taxpayer's replacement tires and tubes would be depreciated in the same manner as Taxpayer's new tires and tubes. Therefore, Taxpayer's replacement tires and tubes would have a recovery period of 5 years for purposes of section 168(a), and 8 years for purposes of section 168(g).

Rev. Rul. 2004-18 [environmental remediation costs]Issue

Are costs incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing plant includible in inventory costs under §263A of the Internal Revenue Code?

Facts

X, a corporation using an accrual method of accounting, owns and operates a manufacturing plant that produces property that is inventory in X's hands. X's manufacturing operations discharge hazardous waste. In the past, X buried this waste on portions of X's land. The land was not contaminated by hazardous waste when purchased by X.

In order to comply with applicable federal, state, and local environmental requirements, X incurs costs (within the meaning of §461(h)) to remediate the soil and groundwater that had been contaminated by the hazardous waste, and to establish an appropriate system for the continued monitoring of the groundwater to ensure that the remediation removes all hazardous waste. The costs X incurs are not research and experimental expenditures within the meaning of §174 or environmental management policy costs. The soil remediation and groundwater treatment restores X's land to essentially the same physical condition that existed prior to the contamination. During and after the remediation and treatment, X continues to use the land and operate the plant in the same manner as X did prior to the cleanup except that X disposes of any hazardous waste in compliance with environmental requirements.

Law

Section 263A(a) provides that the direct costs and indirect costs properly allocable to property that is inventory in the hands of the taxpayer shall be included in inventory costs.

Section 1.263A-1(a)(3)(ii) of the Income Tax Regulations provides, in part, that taxpayers that produce tangible personal property must capitalize (1) all direct costs of producing the property, and (2) the property's allocable share of indirect costs.

Section 1.263A-1(e)(3)(i) provides, in part, that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. Cost recovery, production facility repair and maintenance costs, and scrap and spoilage costs, such as waste removal costs, are examples of indirect costs that must be capitalized to the extent the costs are properly allocable to produced property. See 1.263A-1(e)(3)(ii) (I), (O) and (Q).

Section 1.263A-1(e)(4)(iv)(I) provides that costs incurred for environmental management policy generally are not allocated to production or resale activities (except to the extent that the costs of any system or procedure benefit a particular production or resale activity).

Section 1.263A-1(c)(2)(ii) provides that the amount of any cost required to be capitalized under 263A may not be included in inventory or charged to capital account or basis before the taxable year during which the amount is incurred within the meaning of §1.446-1(c)(1)(ii). Pursuant to §461(h), in determining whether an accrual method taxpayer has incurred an amount for any item during the taxable year, the all events test shall not be treated as met any earlier than when economic performance occurs.

Section 1.263A-2(a)(3)(i) provides that any cost required to be capitalized by 263A must be capitalized regardless of whether the cost was incurred before, during, or after production.

Rev. Rul. 94-38, 1994-1 C.B. 35, analyzes whether costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from the taxpayer's manufacturing business are capital expenditures. The ruling holds that the costs to clean up land used in the taxpayer's manufacturing process and to treat groundwater are not capital expenditures because these costs do not prolong the useful life of the land or adapt the land to a new or different use. Therefore, costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from the

taxpayer's business are deductible by the taxpayer as business expenses under §162. Costs properly allocable to constructing groundwater treatment facilities, however, are capital expenditures under 263.

Rev. Rul. 98-25, 1998-1 C.B. 998, holds that costs incurred to replace underground storage tanks containing waste by-products under the circumstances in the ruling are not capital expenditures under §263, but are ordinary and necessary expenses under §162.

Analysis

The discussion in Rev. Rul. 94-38 of *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), *nonacq.*, 1964-2 C.B. 8, demonstrates that the revenue ruling was intended to address whether the costs to clean up the land and to treat the groundwater are capital expenditures that must be capitalized into the basis of the land under 263(a) or whether the costs are ordinary and necessary repair expenses under 162. Rev. Rul. 94-38 does not address the treatment of these costs as inventory costs under 263A. Similarly, Rev. Rul. 98-25 does not address whether amounts incurred to replace underground storage tanks must be included in inventory costs under 263A.

The holding of Rev. Rul. 94-38 that the costs to construct a groundwater treatment facility must be capitalized under 263(a) and 263A rather than deducted under 162 demonstrates the distinction between capital expenditures and costs that are more in the nature of repairs than capital improvements. As with other types of deductible business costs, such as labor costs, taxes, rent, and supplies, once repair costs are determined to be deductible under 162, a taxpayer with inventories must still apply the rules of 263A to determine whether the repair costs must be included in inventory. Section 1.263A-1(e)(3). In addition, if repair costs must be capitalized under 263(a) and 263A to a depreciable asset, a taxpayer with inventories must still apply the rules of 263A to determine whether the depreciation expense must be included in inventory. Section 1.263A-1(e)(3)(ii)(I).

In this situation, X incurs environmental remediation costs to clean up land that was contaminated as part of the ordinary business operations of X's manufacturing of inventory. X's environmental remediation costs are incurred by reason of X's production activities within the meaning of 1.263A-1(e)(3)(i). The costs are properly allocable to property produced by X that is inventory in X's hands under 1.263A-1(e)(3)(i). Accordingly, X must capitalize the otherwise deductible environmental remediation costs by including the costs in inventory costs in accordance with 1.263A-1(c)(3). Similarly, costs incurred to replace underground storage tanks and depreciation cost recoveries of the groundwater treatment facility must be included in inventory costs to the extent properly allocable to inventory.

Holding

Environmental remediation costs are subject to capitalization under 263A. Therefore, costs incurred (within the meaning of 461(h) and 1.263A-1(c)(2)(ii)) to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing plant must be included in inventory costs under 263A.

Transition Rule

This paragraph applies to costs that would have been properly deducted in the taxable year but for the requirement to capitalize the costs to inventory under § 263A, and for which the taxpayer's method of accounting was to deduct the costs. The Internal Revenue Service will not challenge the treatment of environmental remediation costs to which this paragraph applies as deductible expenses rather than as costs properly capitalized to inventory under § 263A in any taxable year ending on or before February 6, 2004. Therefore, the treatment of environmental remediation costs to which this paragraph applies as amounts properly capitalized to inventory under § 263A will not be raised as an issue in any taxable year ending on or before February 6, 2004, and, if the treatment of such environmental remediation costs as deductible expenses rather than as amounts properly capitalized to inventory under § 263A has already been raised as an issue in examination or before Appeals or the Tax Court in a taxable year ending on or before February 6, 2004, the issue will not be further pursued. The Service will not impose penalties on taxpayers or preparers for treating environmental remediation costs to which this paragraph applies as

deductible expenses rather than as costs properly capitalized to inventory under § 263A in taxable years ending on or before February 6, 2004.

Change In Method Of Accounting

A taxpayer using a method of accounting that does not comply with this revenue ruling is using an impermissible method of accounting. Any change in a taxpayer's treatment of environmental remediation costs to conform with this revenue ruling is a change in method of accounting to which the provisions of §446 and §481 and the regulations thereunder apply. A taxpayer changing its method of accounting to comply with this revenue ruling must file a Form 3115 in accordance with the automatic change in method of accounting provisions of Rev. Proc. 2002-9, 2002-1 C.B. 327, as amplified, clarified and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432, and Rev. Proc. 2002-19, 2002-1 C.B. 696, with the following modifications: (1) the scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to make the change for its first taxable year ending after February 6, 2004; and (2) a taxpayer that files a Form 3115 in accordance with this revenue ruling to make the change in method of accounting for its first taxable year ending after February 6, 2004, may effect the change using either a 481(a) adjustment as provided in sections 5.03 and 5.04 of Rev. Proc. 2002-9 or a cut-off method. For purposes of Line 1a of Form 3115 (revised December 2003), the designated number for the automatic accounting method change authorized by this revenue ruling is "77." A taxpayer making the automatic change in method of accounting authorized by this revenue ruling and another automatic change in method of accounting under § 263A for the same taxable year may file one Form 3115 to make both changes, but must comply with the ordering rules of § 1.263A-7(b)(2) and must enter the automatic accounting method change numbers for both changes on Line 1a of Form 3115 (revised December 2003).

Effect On Other Documents

Rev. Rul. 98-25 and Rev. Rul. 94-38 are clarified by providing that the otherwise deductible amounts at issue in Rev. Rul. 98-25 and Rev. Rul. 94-38 are subject to capitalization to inventory under 263A.

Rev. Proc. 2002-9 is modified and amplified to include in the APPENDIX the automatic change provided in this revenue ruling.

Plan of Rehabilitation and §1.162-4 and §263(a)

Moss v. Commissioner, 60 AFTR 2d 87-5910, 831 F.2d 833 (9th Cir)

By this appeal, Jerome and Sandra Moss, Sharon Alesia, and Herb and Lani Alpert ("taxpayers") challenge the tax court's holding in *Moss v. Commissioner*, 51 T.C.M. (CCH) 742 (1986), that the taxpayers must capitalize certain normally deductible repair expenses totaling \$270,268 because the expenses were incurred in conjunction with an overall plan of capital improvements to a hotel. The parties have stipulated to most of the relevant facts, and the taxpayers do not contest the tax court's findings of other facts. We note jurisdiction under 26 U.S.C. §7482 (1982) and reverse.

Factual Background

The taxpayers are general and limited partners in Almo Hotel Company, Ltd. ("Almo"), a California limited partnership. In 1976, the tax year in question, Almo was the sole fee owner of the Hyatt House Hotel ("the Hotel"), located near the Los Angeles International Airport. The Hotel was constructed in 1963 and was known as the International Hotel prior to 1975. It is a thirteen-story, reinforced concrete building with approximately 620 guest rooms, two large restaurants, two cocktail lounges, a large ballroom, more than a dozen smaller conference rooms, and numerous retail stores. The Hotel was purchased in 1967 for \$12,600,000 by Almo Enterprises, a California limited partnership having the same partners as Almo, and was transferred to Almo in 1975. The purchase price included the acquisition of the Hotel land and buildings only, and the furnishings, equipment, and supplies used in operating the Hotel were supplied and owned by the Hotel's tenant. At all relevant times, Almo leased the Hotel land and

buildings under a master lease to Ariz, a California limited partnership. For management purposes, Ariz in turn subleased the Hotel to Airportel, Inc. ("Airportel"). Prior to 1975, Airportel's management performance was guaranteed by its then-parent corporation, International Airport Hotel Systems, Inc. ("IAHS"). As an IAHS subsidiary, Airportel operated the Hotel under a triple-net lease and was responsible for all repairs and maintenance, as well as for purchasing and replacing the furniture, fixtures, equipment, and machinery necessary to operate the hotel.

Prior to 1975, the American Automobile Association ("AAA") consistently assigned the Hotel an "excellent" rating.¹ Because hotels operate twenty-hours a day, 365 days a year, they are continuously in need of maintenance work and refurbishing. A first-class hotel must therefore make repairs and replace furniture, furnishings, and equipment on an ongoing basis pursuant to an annual plan and budget. However, owing to financial difficulties encountered by Airportel and IAHS, part of the Hotel's normally ongoing program of capital replacements and repairs was deferred during the early 1970's. As a consequence, the Hotel's AAA rating slipped one level from "excellent" in the 1974/1975 AAA Tour Book to "very good" in the 1975/1976 AAA Tour Book.

In 1975, Almo and Ariz released IAHS from its guarantor responsibilities in return for all of Airportel's stock and some cash and notes. Almo and Ariz then sought new management for the Hotel and negotiated with both Hilton Corporation ("Hilton") and Hyatt Corporation ("Hyatt"). Owing to Airportel's deferral of some repairs and capital replacements during the preceding two or three years, both Hilton and Hyatt recommended that approximately \$2,000,000 in capital improvements and repairs be made to the Hotel.

In August 1975, Airportel (now owned by Almo and Ariz) entered into a written management agreement with Hyatt. Pursuant to the terms of the management agreement, Airportel agreed to spend up to \$2,000,000 on capital improvements and repairs to be proposed later by Hyatt. In turn, Hyatt agreed to finance these improvements and repairs to the Hotel by lending \$2,000,000 to Airportel. Due to concerns that the newly-acquired Airportel stock might be subject to unknown liabilities, Almo and Ariz formed a California joint venture called Almo/Ariz for the purpose of accepting Hyatt's loan and carrying out the improvements and repairs.

The capital improvements and repairs were commenced in November 1975, and were completed in 1976, with the Hotel continuing to operate throughout that period. About 400 of the Hotel's 620 guest rooms underwent both a "hard remodel" (beds, chairs, tables, and lamps) and a "soft remodel" (new carpeting, drapes, and bedspreads). Additionally, most of the Hotel's public areas were remodeled. The foregoing capital improvements cost a total of \$1,486,915.² Almo/Ariz capitalized these improvements pursuant to 26 U.S.C. §263(a)(1) (1982), depreciated the cost over a seven year useful life, and leased the improvements to Airportel.³ The Commissioner has not challenged the tax treatment of the foregoing expenditures.

In conjunction with the remodeling, Almo/Ariz also spent about \$400,000 of the Hyatt loan on repairs and maintenance work, including the repainting and repapering of the remodeled guest rooms and public areas. Pursuant to 26 U.S.C. §162(a) (1982), Almo/Ariz treated the expenditure as an ordinary and necessary repair expense, deducting from its income \$132,140 in 1975 and \$270,268 in 1976.

The \$270,268 deducted by Almo/Ariz in 1976 is the subject of this appeal.⁴ Portions of the \$270,268 flowed through Almo/Ariz and Almo to the taxpayers, who deducted their proportionate shares on their personal income tax returns for 1976. However, the Commissioner assessed deficiencies against the taxpayers, claiming that the \$270,268 should have been capitalized and depreciated over the Hotel structure's remaining thirty-year useful life. In the taxpayers' appeal to the tax court, the Commissioner conceded that "the particular items deducted by Almo/Ariz as repairs 'were of the *type* (i.e., painting, wallcovering, etc.) of items that normally qualify as repair expense items.'" Moss, 51 T.C.M. (CCH) at 746. However, the tax court held in favor of the Commissioner, finding that the repairs were made in conjunction with a plan of capital improvements to the Hotel property and were thus required to be capitalized. Id. at 747.

The Plan Of Rehabilitation Doctrine

Generally speaking, expenditures for ordinary and necessary repairs may be deducted in the year incurred, while expenditures for permanent improvements or betterments made to increase the value of any property must be capitalized and depreciated over the useful life of the improvement. See 26 U.S.C. §§162(a), 263(a)(1) (1982).⁵ The often-litigated distinction between repair expenses and capital improvements has been characterized as the difference between "keeping" and "putting" a capital asset in good condition:

The test which normally is to be applied is that if the improvements were made to "put" the particular capital asset in efficient operating condition, then they are capital in nature, If, however, they were made merely to "keep" the asset in efficient operating condition, then they are repairs and are deductible.

Estate of Walling v. Commissioner, 373 F.2d 190, 192-93 (3d Cir. 1967). According to the Commissioner's 1976 repair regulation, "[t]he cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense." 26 C.F.R. §1.162-4 (1976). However, amounts expended in restoring property must be capitalized if they add to the value of the property, substantially prolong its life, or adapt the property to a new or different use. 26 C.F.R. §1.263(a)-1(a), (b) (1976).

In this case, the Commissioner concedes that the items expensed by the taxpayers "were of the type ... that normally qualify as repair expense items." However, a number of cases have recognized that, for tax purposes, the characterization of an expenditure as a deductible repair or as a capital improvement depends on the context in which the expenditure is made. See e.g., *Stoeltzing v. Commissioner*, 266 F.2d 374, 377 (3d Cir. 1959); *Jones v. Commissioner*, 242 F.2d 616, 619 (5th Cir. 1957); *Cox v. Commissioner*, 17 T.C. 1287, 1293 (1952); *Cowell v. Commissioner*, 18 B.T.A. 997, 1002 (1930). For example:

To fix a door or patch plaster might very well be treated as an expense when it is an incidental minor item arising in the use of the property in carrying on business, and yet ... be properly capitalized when involved in a greater plan of rehabilitation, enlargement and improvement of the entire property.

Cowell, 18 B.T.A. at 1002. These cases also analogize to the treatment of repair-like expenditures incurred in the construction of a new asset. As observed in *Stoeltzing*, 266 F.2d at 377:

If [the taxpayer] had erected a completely new building, items of work which the contractor might have undertaken to prepare the building for occupancy such as carting away refuse or painting or even washing windows, could hardly be separated from the whole cost and deducted as expenses.⁶

In light of the contextual nature of the inquiry, "the courts have superimposed upon the criteria in the [Commissioner's] repair regulation an overriding precept that an expenditure made for an item which is part of a 'general plan' of rehabilitation, modernization, and improvement of the property, must be capitalized, even though, standing alone, the item may appropriately be classified as one of repair." *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968). Whether such a plan exists depends upon "a realistic appraisal of all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done, e.g., whether the work was done to suit the needs of an incoming tenant, or to adapt the property to a different use, or ... whether what was done resulted in any appreciable enhancement of the property's value." *Id.* at 690. Pursuant to this plan of rehabilitation doctrine ("rehabilitation doctrine"), the taxpayer in *Mountain Fuel Supply Co. v. United States*, 449 F.2d 816 (10th Cir. 1971), cert. denied, 405 U.S. 989 (1972), was required to capitalize the entire cost of unearthing, cleaning, transporting, reconditioning, testing, and reburying forty miles of underground pipe that, after thirty years of use, had developed a bad history of leaks. And in *Stoeltzing*, 266 F.2d at 375-76, the doctrine was applied to a taxpayer who had made substantial capital improvements and repairs to a

building "in a bad state of repair" and had attempted to deduct an amount that "exceeded by almost 200% the ascribed cost of the building."

In this case, the tax court considered the factors enumerated in Wehrli and concluded that "a general plan of capital improvements was in effect during the taxable year in issue, specifically, for the renovation, remodeling and improvement of the hotel." Moss, 51 T.C.M. (CCH) at 747. It found that "although the hotel remained in very good operating condition its 'tired' interior condition was plainly visible," and "from both a functional and aesthetic standpoint, the hotel's furnishings, fixtures and design were somewhat obsolete and required remodeling." Id. at 744. The management agreement between Airpotel and Hyatt clearly provided "for a single and complete program of improvements," and "[t]he particular items deducted as repair expenses ... were pursuant to this general scheme of improvements." Id. at 747. Although the tax court found that the "improvements were not made to the hotel's structure" and only had a useful life "anticipated to be approximately 3 to 5 years," id.,⁷ it concluded that the improvements "added to the life of the hotel property," id. at 748. The tax court observed that "[e]ven though the hotel [had] always enjoyed high ratings," its increased value was evidenced by its "newly acquired four-star rating in 1978." Id. At 747. Based on these facts, the tax court concluded that "[t]he plan of improvements doctrine requires that the entire cost of all the expenses must be capitalized." Id.⁸

The taxpayers concede that they had a written plan of capital improvements for the Hotel, but contend that the rehabilitation doctrine must certainly require more than the mere existence of some formal plan combining capital improvements and repairs. They correctly point out that what the tax court described as "the hotel property" is comprised of different capital assets with different useful lives. The taxpayers argue that the rehabilitation doctrine should only be triggered by a plan that calls for substantial capital improvements and repairs to the same particular asset, i.e., the structure of a building. In this case, the taxpayers made no capital improvements to the Hotel structure. Their plan consisted only of replacing capital assets such as drapes, carpeting, and furniture—assets that are distinct from the Hotel structure and that have much shorter useful lives. The taxpayers find it anomalous that they should be required to depreciate normally deductible repair expenses over the thirty-year life of the Hotel structure merely because the expenses were incurred in conjunction with the replacement of other capital assets having three-to-five-year useful lives.

The taxpayers further argue that, even if the rehabilitation doctrine can be triggered by capital improvements and repairs to different assets, their plan was not one of total rehabilitation as contemplated by the cases by applying the doctrine. They contend that the capital replacements and repairs made to the Hotel in 1976 were consistent with the type of capital replacements that any first-class hotel must make on an ongoing basis to remain competitive and in efficient operating condition. According to the taxpayers, the judicial decisions employing the court-created rehabilitation doctrine do not support its application to the facts presented in this case.

Issue Presented

Whether the rehabilitation doctrine requires the taxpayers to capitalize certain normally deductible repair expenses and to depreciate them over the remaining thirty-year life of the Hotel structure because the repairs were made as part of a plan to remodel the Hotel with furniture and furnishings having an anticipated three-to-five year useful life.

...

Discussion

The taxpayers contend that since they made no capital improvements to the Hotel structure itself, the tax court erred in concluding that a plan of rehabilitation existed for that particular capital asset. They rely on cases that explain the conceptual basis for the rehabilitation doctrine by analogizing to the treatment of repair-like expenditures incurred in the construction of a new asset. See, e.g., Stoeltzing, 266 F.2d at 377; Bank of Houston, 19 T.C.M. (CCH) at 592. When both substantial capital improvements and repairs are made to a particular asset at the same time, the distinction between the capital improvements and repairs

disappears because all the expenditures combine to change the asset's use, increase its value, or prolong its life. According to the taxpayers, the rehabilitation doctrine is simply a judicial acknowledgement of the foregoing fact. Since the taxpayers' plan consisted only of replacing certain assets—i.e., carpeting, drapes, and furniture—and of repainting and repapering a different asset—i.e., the Hotel structure—the taxpayers contend that there is no difficulty in distinguishing the impact of the capital replacements from the impact of the repairs on the Hotel property. The capital replacements were properly capitalized and depreciated over a useful life that is many times shorter than the remaining useful life of the Hotel structure. The repainting and repapering expenditures did not substantially prolong the life or appreciably add to the value of the Hotel structure. Thus, the taxpayers submit, the conceptual foundation for applying the rehabilitation doctrine is simply not present in this case.

The taxpayers' theory is certainly consistent with the case law. To our knowledge, every case in which the rehabilitation doctrine has been applied to date has involved substantial capital improvements and repairs to the same specific asset, usually a structure in a state of disrepair.¹² Here, however, the Commissioner and the tax court have required the taxpayers to capitalize normally deductible repair expenses to the account of a particular capital asset that was otherwise untouched by the taxpayers' plan. The tax court's application of the doctrine in this case—to a building in very good operating condition and to a remodeling plan involving no structural renovation—marks a broad extension of doctrine's historical scope. Moreover, the incongruous tax consequences of applying the doctrine to the taxpayers' plan would appear to counsel against such an extension.

At the very least, the fact that the taxpayer's plan involved no structural improvements to the Hotel is a significant factor weighing against the application of the rehabilitation doctrine in this case. However, rather than adopting the bright-line rule advanced by the taxpayers, we hold for the taxpayers on narrower grounds. The reasoning of two tax court decisions, both of which were appealed to this court, support the taxpayers' second contention that their plan was simply not of the nature or scope necessary to trigger the rehabilitation doctrine. In *Kaonis v. Commissioner*, 37 T.C.M. (CCH) 792 (1978), *aff'd mem.*, 639 F.2d 788 (9th Cir. 1981), the taxpayer had deducted all costs incurred in renovating a rental house. The tax court found that "these expenditures were in large part capital in nature" and "clearly added to the value of the property and were not made to restore it to its previous condition." *Id.* at 796. However, the tax court allowed the taxpayer to deduct expenditures for repairs such as painting and cleaning. It found the rehabilitation doctrine inapplicable because "the property was tenantable and generally suitable for its use in the trade or business," and "[t]he repairs and additions here were not part of a plan of total rehabilitation such as those contemplated in [cases applying the doctrine.]" *Id.*¹³

In *Keller Street Dev. Co. v. Commissioner*, 37 T.C. 559 (1961), *aff'd in part and rev'd in part on other grounds*, 323 F.2d 166 (9th Cir. 1963), the taxpayer, a brewery, had made some capital improvements in plant and equipment, most of which were designed to increase productive capacity so it could fill increasing demand. The Commissioner argued that certain expenses deducted by the taxpayer should have been capitalized because they were "part of a general betterment program." *Id.* at 567. However, the court declined to apply the rehabilitation doctrine because "the brewery was in operating condition and use during the taxable years in question and had been for several years before." *Id.* at 568. It also found that the "capital improvements made to increase capacity [were] not such as would constitute a general betterment program," and that the few other capital improvements made by the taxpayer "were of the type that must be constantly made by a manufacturer in a competitive industry and therefore [are] not to be considered part of a betterment program." *Id.*

Clearly, *Kaonis* and *Keller* were stronger candidates for application of the rehabilitation doctrine than this case, for they involved substantial capital improvements and repairs to the same structure. In this case, as was true in *Kaonis* and *Keller*, the taxpayers' property was generally suitable for its intended use. Indeed, the tax court specifically found that the Hotel had always enjoyed high ratings, was in very good operating condition, and remained in operation throughout the period of remodeling. The foregoing facts are certainly not dispositive of whether the rehabilitation doctrine should be applied in a particular case. However, they support our conclusion that the taxpayers' plan in 1976 was consistent with the type of

annual maintenance activities necessary to maintain the Hotel in first-class condition, and that the tax court erred in applying the rehabilitation doctrine to the facts of this case.

While the tax court expressly rejected the taxpayers' contention that their plan was consistent with the Hotel's ongoing maintenance needs, its conclusion was based on faulty reasoning rather than on any factual findings. The taxpayers introduced evidence of their annual expenditures on repairs and capital improvements from 1977 and 1984 to demonstrate that the expenditures in 1976 were consistent with the Hotel's ongoing program of maintenance and capital replacements. The tax court, however, dismissed the evidence as only establishing that the 1976 expenditures were "more consistent with Hyatt's management style and recommendations, rather than any such ongoing program of [the taxpayers]." Moss, 51 T.C.M. (CCH) at 748. The tax court apparently failed to realize that, prior to November 1975, the taxpayers never had their own ongoing program of hotel maintenance. They had always leased the Hotel land and structures under a triple-net lease to Airpotel, then an IAHS subsidiary. The taxpayers' program has always been based on Hyatt's management style and recommendations. Thus, the taxpayers' annual expenditures from 1977 and 1984 are clearly persuasive evidence, and perhaps the best evidence, of the scope of annual maintenance and capital replacement necessary to maintain the Hotel as a competitive, first-class establishment.

Nor is our holding inconsistent with any of the tax court's findings of the basic, primary, or historical facts underlying this case. Given the tax court's express finding that the plan's capital replacements had useful lives of three to five years, we would expect the taxpayers or Hyatt to remodel from 120 to 200 rooms on an annual basis just to maintain the Hotel in good operating condition. Thus, in 1976, the taxpayers essentially accomplished two solid years of remodeling in one year. Moreover, the tax court found that the taxpayers actually commenced their plan in November 1975. Had the taxpayers started remodeling the Hotel's interior a few months earlier, completing 200 guest rooms in 1975 and 200 guest rooms in 1976, the plan would have fallen squarely within the normal range of ongoing Hotel maintenance activities. As observed by one of the Commissioner's witnesses, and as found by the tax court, the expenditures in 1976 were " 'on the high side' " for a given year. *Id.* at 747. We do not think, however, that the rehabilitation doctrine is so rigid that the tax consequences to the taxpayers should be drastically altered by minor variations in the Hotel's pattern of annual capital replacements and repairs. Given that the Hotel must completely remodel its interior every three to five years in order to remain competitive, there may be sound business reasons why the taxpayers or management may wish to accomplish the bulk of capital replacement in a particular year rather than spreading it out evenly over each year in the cycle.¹⁴

The tax court concluded that the Hotel's increased value was evidenced by its "newly acquired [AAA] four-star rating in 1978." *Id.* at 747. However, the taxpayer's plan was completed in 1975 and 1976, and the Hotel had consistently enjoyed an "excellent" rating—the pre-1977 equivalent to four stars—up until the very year that the remodeling program was commenced. Thus, the taxpayers' plan of improvements really only served to maintain the four-star status of the Hotel. Even if there was a brief decline in the Hotel's AAA rating prior to November 1975, that does not alter the fact that the scope of the taxpayers' plan was generally consistent with the Hotel's ongoing maintenance needs.

In its opinion, the tax court emphasized that the taxpayers' expenditures were pursuant to a written plan and that the improvements were of great importance to both the taxpayers and Hyatt. The tax court stressed that the Hyatt/Airpotel management agreement "required the completion of 'substantial repairs and improvements'... [including] improvements, additions and alterations to the hotel." Moss, 51 T.C.M. (CCH) at 747. However, it is well-settled that tax consequences are determined by "what in fact was done rather than by the mere form of words used in the writings employed." *Tex-Penn Oil*, 300 U.S. at 493. The mere existence of a written plan is not sufficient to trigger the rehabilitation doctrine. Any commercial enterprise, such as the Hotel in this case, that annually spends large sums of money on capital replacements and repairs certainly must do so pursuant to a detailed plan and budget.

Conclusion

In applying the rehabilitation doctrine, the court must evaluate the taxpayers' expenditures in the context of the taxpayer's particular business enterprise. We conclude that the taxpayers' remodeling plan in 1976 was consistent with the type of capital replacement and repair expenditures that the Hotel must continuously make in order to remain competitive and in first-class condition. This case is clearly distinguishable from those cases in which the rehabilitation doctrine has been invoked, and it would be anomalous to require the taxpayers to depreciate normally deductible repairs over thirty years merely because the repairs were made in conjunction with the installation of furnishings having a three-to-five-year useful life. Accordingly, we hold that the rehabilitation doctrine is inapplicable to the facts of this case, and that the taxpayers properly deducted the \$260,278 in repairs as ordinary and necessary business expenses. The tax court's decision is reversed.

Reversed.

[1](#)

Prior to 1977, the AAA rated hotels under five categories: fair, good, very good, excellent, and outstanding. After 1977, the AAA began rating hotels under a system of one to five stars, with five stars being the equivalent of "outstanding" under the previous rating system.

[2](#)

Almo/Ariz capitalized the following improvements financed by the Hyatt loan:

Electric "Hyatt House" sign	\$ 58,278
Carpeting	251,692
Drapes	178,288
Hotel furnishings	696,510
Dining and kitchen furnishings	297,562
Office equipment	4,585

Total capital expenditures	\$1,486,915

[3](#)

Almo/Ariz actually leased the improvements to a new entity, Alar Corporation, which was Airportel's successor-in-interest and was owned by Almo and Ariz.

[4](#)

The Commissioner did not audit the 1975 return filed by Almo/Ariz and does not challenge the \$132,140 in repairs claimed by Almo/Ariz and the taxpayers in 1975.

[5](#)

References herein to Title 26 are to the Internal Revenue Code of 1954, as amended and in effect in 1976, the tax year in issue.

[6](#)

See also *Bank of Houston v. Commissioner*, 19 T.C.M. (CCH) 589, 592 (1960) ("The construction of a new building encompasses numerous steps, many of which, when viewed alone, might in the everyday, commonly accepted sense, be considered repair items. But, taken as a whole, the cost of the construction is capitalized.")

[7](#)

Although the taxpayers depreciated the plan's capital replacement over seven years, there was uncontroverted testimony that the Hotel had an ongoing plan of completely remodeling its rooms every three to five years.

[8](#)

The tax court did not specifically identify the particular asset account to which the \$270,268 was to be capitalized. However, it seems apparent that the tax court intended to affirm the Commissioner's determination that the expenditures were to be capitalized to the Hotel's structure and depreciated over the structure's remaining thirty-year useful life.

[9](#)

Mixed questions are those in which "the historical facts are admitted or established, the rule of law is undisputed, and the issue is whether the facts satisfy the statutory standard." *Pullman-Standard v. Swint*, 456 U.S. 273, 289 n. 19 (1982).

[10](#)

Arguably, one might characterize the taxpayers' appeal as a challenge to the tax court's factual determination that the taxpayers' plan rehabilitated the Hotel structure. The tax court, however, made no such factual finding. Rather, it determined that the taxpayers' plan added to the value and life of "the hotel property" as a whole. *Moss*, 51 T.C.M. (CCH) at 747-48. The tax court's holding was based on its legal conclusion that, in applying the rehabilitation doctrine, the entire Hotel property (i.e., the buildings, furnishings, fixtures, machinery, and equipment) should be viewed as a single, indivisible asset.

[11](#)

See also *Katherine Lynn McCarthy Trust v. Commissioner*, 817 F.2d 558, 559 (9th Cir. 1987) (holding that, when the parties do not dispute the substance of the transaction, "[a]pplication of the Internal Revenue Code ... is a question of law subject to de novo review"); *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1047 n. 3 (9th Cir. 1976) (contrasting cases that "deal with purely factual questions to which the legal conclusion is clear" with the case in which "the factual issues [are] generally undisputed with only the legal implications uncertain"); *Lundgren v. Commissioner*, 376 F.2d 623, 627 (9th Cir. 1967) (when the determination whether a particular loss or expense was incurred in the taxpayer's trade or business involves the interpretation of a statute, "the question is a mixed one of law and fact and is subject to review by this court"); *Commissioner v. Boeing*, 106 F.2d 305, 309 (9th Cir.) (Board of Tax Appeals' findings that the taxpayer's gains and losses resulted from sales of capital assets rather than stock in trade were "conclusions of law, or mixed questions of law and fact ... subject to independent judicial review"), cert. denied, 308 U.S. 619 (1939).

[12](#)

See, e.g., *Wehrli*, 400 F.2d at 688 (building air-conditioned; interior space rearranged by tearing out hallway, load-bearing wall, and vaults; new wall partitions and floor covering installed; restrooms relocated; new electrical wiring and plumbing fixtures installed); *Jones*, 242 F.2d at 617, 620 (taxpayer completely renovated a structure that had been declared "unfit for habitation" and characterized his work as "more like the reconstruction of a building gutted by fire than ordinary repairs to old apartments' "); *Hubble v. Kavanagh*, 54-1 U.S. Tax Cas. (CCH) ¶9364 at 45,826 (E.D. Mich. 1954) (taxpayer required by building, safety, health, and fire regulations to structurally rehabilitate rooming houses that were "bug-ridden, rat-infested, badly in need of repairs, unsafe for dwelling purposes, and hardly fit for human habitation"), *aff'd per curiam*, 220 F.2d 753 (6th Cir. 1955); *California Casket Co. v. Commissioner*, 19 T.C. 32, 37 (1952) (taxpayer restored entire foundation system of a building that "was unsuited for safe use and occupancy by any business"); *Cox*, 17 T.C. at 1293 (taxpayer renovated building that "had been vacant for two years or more and had fallen into a state of disrepair"); *Home News Publishing Co. v. Commissioner*, 18 B.T.A. 1008, 1009 (1930) (building inspector considered building "unsafe" for occupancy, and taxpayer replaced inadequate wooden girders, installed new glass front to first floor of the building, inserted a window in one of the walls, put down new floors, and repaired the walls, partitions, and ceilings); *Cowell*, 18 B.T.A. at 1000 (electrical wiring and plumbing replaced, new heating system installed, entire building jacked up and superstructure reinforced with steel supports, roof repaired, and interior reconstructed); *Barron v. Commissioner*, 22 T.C.M. (CCH) 1655, 1658 (1963) (at time of trial, taxpayers, expenditures to recondition unrentable apartment building exceeded two-thirds of the purchase price, and the work was only one-third completed); *Bank of Houston*, 19 T.C.M. (CCH) at 590 (sections of floor replaced, wiring repaired and replaced, waste and water plumbing repaired, steam lines relocated, window frames repaired and windows replaced, and interior wall removed).

[13](#)

Below, the tax court attempted to distinguish *Kaonis* from this case. It observed that the tax court in *Kaonis* "held that the repairs performed by the taxpayer merely restored the property to its prior condition but did not add to its value nor prolong its life." *Moss*, 51 T.C.M. (CCH) at 748. However, the tax court's analysis of *Kaonis* was flawed. In applying the rehabilitation doctrine, the proper focus is on the impact of the entire plan of capital improvements, and not simply on the impact of the repairs. By definition, repairs do not add to the value of property or prolong its life. As we previously noted, the *Kaonis* court expressly found that the capital improvements undertaken by the taxpayer "clearly added to the value of the property and were not made to restore it to its previous condition," but concluded that the repairs and capital improvements were not so extensive as to trigger the rehabilitation doctrine. *Kaonis*, 37 T.C.M. (CCH) at 796.

We also find significant the Commissioner's concession at oral argument that, had the taxpayers made the same type of capital improvements to a rental house rather than to a large hotel, they would have been entitled to treat their painting and wallpapering expenses as deductible repairs. The Commissioner attempted to distinguish Kaonis from this case by pointing to the "magnitude" of the taxpayers' plan. However, no authority has been called to our attention to support the proposition that the tax consequences of qualitatively identical remodeling plans should vary depending upon the size of the taxpayer's building.
[14](#)

By accomplishing the bulk of a particular cycle's capital replacements in one particular year, the Hotel might reduce its material and labor costs, minimize the disruptions to its operations, or better preserve stylistic consistency throughout the Hotel.

For example, as part of its findings, the tax court adopted testimony that, when Hyatt took over the Hotel in 1975, its interior was "tired." Moss, 51 T.C.M. (CCH) at 744. According to Mr. Sam Cala, Hyatt's Director of Engineering at the Hotel, the Hotel was "tired" because

the carpets ... were a little brighter than I would have liked, ... the design wasn't exactly [to] my liking. ... the chandeliers weren't all that pretty, but they were there; they were working. The restaurants were dark red [in color] ... [I]n my opinion, I felt that it could ... have been remodeled

Thus, it is apparent from the testimony that the expanded scope of capital replacements in 1976 was in large part designed to give the Hotel a "look" that was in keeping with Hyatt's stylistic preferences. Requiring the Hotel to spread its capital replacements evenly over its three-to-five year cycle, on pain of suffering severe adverse tax consequences, would unnecessarily handicap the Hotel in its efforts to maintain fashionable and stylistically consistent decor throughout its interior.

Debt and Basis

If you purchase a \$400,000 home using \$100,000 of cash and obtain a mortgage of \$300,000, you'd say your basis in the home is \$400,000 (plus any acquisition costs you incurred). Thus, you already know that generally, debt used to acquire property is part of basis. Various court cases have addressed unusual fact patterns involving non-recourse debt, debt that exceeds the FMV of the related property, and some unusual tax shelter cases where transactions were designed to purposefully use debt to inflate the basis of property.

In addition to the *Crane* case (331 US 1 (1947)), also consider the following summarized cases to understand the relevance of debt to property basis.

Estate of Charles T. Franklin v. Comm'r., 544 F2d 1045, 38 AFTR 2d 76-6164, 76-2 USTC ¶9773, (9th Cir. 1976) – This case involved a tax shelter where a California limited partnership purportedly purchased a motel in Arizona. The purchase price was \$1,224,000 to be paid over 10 years, plus interest. Prepaid interest of \$75,000 was due immediately, with monthly payment of approximately \$9,000 for principal and interest for 10 years with a balloon payment of about \$975,000 at the end of 10 years. The debt was nonrecourse. The sale was combined with a leaseback (net lease) to the seller; thus, the partnership never took physical possession. The lease payments were about \$9,000 per month.

The Tax Court and 9th Circuit Court held that there was no bona fide investment in the property; thus, the partnership was not entitled to depreciation deductions. In addition, the debt was not bona fide so the partnership was not entitled to interest deductions.

The 9th Circuit stated:

“An acquisition ... a price approximately equal to the fair market value of the property under ordinary circumstances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale.

No such meshing occurs when the purchase price exceeds a demonstrably reasonable estimate of the fair market value. Payments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then existing fair market value. Under these circumstances the purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase. While this chance undoubtedly influenced the Tax Court's determination that the transaction before us constitutes an option, we need only point out that its existence fails to supply the substance necessary to justify treating the transaction as a sale ab initio. It is not necessary to the disposition of this case to decide the tax consequences of a transaction such as that before us if in a subsequent year the fair market value of the property increases to an extent that permits the purchaser to acquire an equity.⁵

... It is fundamental that "depreciation is not predicated upon ownership of property *but rather upon an investment in property*. *Gladding Dry Goods Co.*, 2 BTA 336 (1925)." Mayerson, *supra* at 350. (italics added). No such investment exists when payments of the purchase price in accordance with the design of the parties yield no equity to the purchaser. ...

Authority also supports disallowance of the interest deductions. This is said even though it has long been recognized that the absence of personal liability for the purchase money debt secured by a mortgage on the acquired property does not deprive the debt of its character as a bona fide debt obligation able to support an interest deduction. Mayerson, *supra* at 352. However, this is no longer true when it appears that the debt has economic significance only if the property substantially appreciates in value prior to the date at which a very large portion of the purchase price is to be discharged. Under these circumstances the purchaser has not secured "the use or forbearance of money." See *Norton v.*

Commissioner, 474 F.2d 608, 610 (9th Cir. 1973). Nor has the seller advanced money or forborne its use. See *Bornstein v. Commissioner*, 334 F.2d 779, 780 (1st Cir. 1964); *Lynch v. Commissioner*, 273 F.2d 867, 871-872 (2d Cir. 1959). Prior to the date at which the balloon payment on the purchase price is required, and assuming no substantial increase in the fair market value of the property, the absence of personal liability on the debt reduces the transaction in economic terms to a mere chance that a genuine debt obligation may arise. This is not enough to justify an interest deduction. To justify the deduction the debt must exist; potential existence will not do. For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price. ... Compare *Crane v. Commissioner*, 331 U.S. 1, 11-12 (1947).”

“⁵ These consequences would include a determination of the proper basis of the acquired property at the date the increments to the purchaser's equity commenced.”

Odend'hal v. Comm'r., 748 F.2d 908, 55 AFTR 2d 85-319, 84-2 USTC ¶9963 (4th Cir.)

Taxpayer purchased a warehouse and food processing facility in 1972 for \$80,000 cash and nonrecourse notes of \$3,920,000 secured by the property. The Tax Court ruled that the FMV of the property was only \$2,000,000 and that the large discrepancy between the FMV and the amount of the debt meant that the debt could not be included in taxpayer's depreciable basis. The Tax Court also held that the taxpayer could only deduct interest and other items to the extent of the income from the property. The 4th Circuit upheld the Tax Court decision, but remanded the case back to the Tax Court for a determination of how any allowable deduction was to be apportioned between interest, rental expenses, taxes and depreciation.

The 4th Circuit stated:

“If, as a matter of fact, the fair market value of the property is less than that financed by a nonrecourse loan, the authorities hold that the principal of the nonrecourse loan which exceeds fair market value does not represent a real investment in the property by a taxpayer and he may not include that nonrecourse amount in his basis for depreciation. See *Brannen v. Commissioner*, 722 F.2d 695 (11 Cir. 1984). In addition, the interest paid on the loan is not allowable as an interest deduction. *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9 Cir. 1976). Basis for depreciation usually includes the amount of any indebtedness incurred or assumed by the purchaser in connection with the purchase of the property, see *Crane v. Commissioner*, 331 U.S. 1 (1947), because the taxpayer has an obligation to pay the debt. When the debt is a nonrecourse loan, the principal amount of the loan is included in the taxpayer's basis so long as the fair market value of the property is at least equal to the amount of the nonrecourse debt at the time it was incurred, because the taxpayer, even though he has no personal liability at stake, has an economic incentive to pay off the debt rather than to lose the collateral. But if the stated price financed by nonrecourse debt exceeds the fair market value of the property, to the extent of the excess, the taxpayer has no equity in the property to protect and no economic incentive to pay off the debt.

Taxpayers contend, however, that *Commissioner v. Tufts*, 461 U.S. 300, (1983), requires that, irrespective of market value or income from the property, the Commissioner is required to recognize the principal amount of the nonrecourse obligation as part of the basis for depreciation and the interest payable thereon as a deductible expense. Our analysis and understanding of *Tufts* is to the contrary.

...

We see nothing, however, in *Tufts* to indicate that the nonrecourse debt in the instant case must be recognized for purposes of computing allowable depreciation or allowable interest deductions. The instant case is not one where, having taken depreciation on property on a basis which includes nonrecourse debt incurred in acquisition of the property, a taxpayer seeks to ignore a transfer of the nonrecourse debt in computing gain or loss from a subsequent sale of the property. The issue here is what are proper deductions for depreciation and interest. We see nothing in *Tufts* to alter the well-established rules that a taxpayer may not inflate his depreciation deductions, as did taxpayers here, by including in his basis for

depreciation nonrecourse debt when that debt so far exceeds actual value at the time that it is incurred that there is no economic incentive to pay it, and similarly that a taxpayer may not claim an interest deduction where he has neither personal liability nor economic incentive to pay. [*Tufts*] emphasized that Crane was "predicated on the assumption that the mortgage will be repaid in full," *id.* at 308, and that "the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay." *Id.* at 309. This crucial assumption is lacking in our case. Since the value of the property failed to approach the amount of prior liens and the face amount of the nonrecourse obligations to RCA, taxpayers had no economic incentive to repay the obligations at issue here."

Action on Decision 1991-009

Re: George Prussin and Sharon Prussin v. Commissioner

Opinion: 863 F.2d 263 (3d Cir. 1988), reh'g denied, remanding *Pleasant Summit Land Corporation v. Commissioner*, T.C. Memo. 1987-469

ISSUE:

Whether nonrecourse debt that substantially exceeds the fair market value of the property is includible in the basis of the property securing the debt.

DISCUSSION:

The taxpayers invested in a limited partnership which was organized to syndicate interests in an apartment complex. The partnership purchased buildings for \$7,759,200, \$7,259,200 of which was financed by nonrecourse debt. The Tax Court concluded that the fair market value of the property (land and buildings) could not have exceeded \$4,200,000 and, thus, reasoned that no part of the nonrecourse debt was includible in basis. This is consistent with all prior opinions on this issue which have held that nonrecourse indebtedness should not be treated as genuine indebtedness if, at the time of acquisition, the principal amount of the debt greatly exceeds the fair market value of the property securing the debt. See *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976); *Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984); *Narver v. Commissioner*, 670 F.2d 855 (9th Cir. 1982); *Oden'hal v. Commissioner*, 748 F.2d 908 (4th Cir. 1984); *Estate of Isaacson v. Commissioner*, 860 F.2d 55 (2d Cir. 1988).

The Third Circuit held that nonrecourse indebtedness which unreasonably exceeded the property's fair market value would be includible in the property's basis up to the fair market value of the property at the time of purchase for purposes of computing depreciation deductions. Further, as the Tax Court held upon remand, the Third Circuit determined that the basis would include the cash downpayment. *Prussin v. Commissioner*, T.C. Memo. 1990-287. Additionally, such nonrecourse indebtedness would support interest deductions based on the fair market value of the property. The Third Circuit reached this conclusion because it believed that any rational lender would be willing to compromise the debt down to the fair market value of the property.

No rational lender would routinely compromise the debt down to fair market value as of the date of purchase where the property has appreciated in value by the time of default. If the property declined in value, the lender might be willing to compromise and accept payment on the note equal to the fair market value at the time of purchase, but no rational borrower would pay the former fair market value amount where the value of the property has declined. If the property remains at the same value, each party might be willing to compromise the debt down to the fair market value; but the borrower would still have no equity in the property to protect, so it could just as prudently abandon the property.

The Third Circuit's analysis overlooks the fact that the taxpayers are not personally liable for the indebtedness. They have no economic incentive to make payments on the debt unless the property appreciates to the point where the debt is more in line with the property's value. See *Estate of Franklin*, 544 F.2d at 1048; *Oden'hal*, 748 F.2d at 912. Where it is, the borrower has an economic incentive to pay

off the debt in order to preserve its equity in the property. Under the holding of the Third Circuit, the borrower would have no incentive to compromise for current fair market value because it has no equity in the property and it could, therefore, just as prudently abandon the property. Additionally, inclusion of the cash downpayment in basis would not influence a rational borrower's decision whether to pay nonrecourse debt because a downpayment creates no equity where the nonrecourse debt exceeds the fair market value of the property.

We believe the Third Circuit's analysis is incorrect and is in conflict with opinions of the Second, Fourth, Ninth and Eleventh Circuits and of the Tax Court. Additionally, the issue has currently demonstrable administrative importance. However, the Supreme Court denied the government's petition for a writ of certiorari on October 10, 1989.

The Service will continue to litigate this issue based on the rationale of *Estate of Franklin*. See *Lebowitz v. Commissioner*, 917 F.2d 1314 (2d Cir. 1990).

RECOMMENDATION:

Continued litigation of issue.

Bergstrom v. US, 37 Fed Cl 164, 79 AFTR 2d 97-305, 97-1 USTC ¶50143 (Fed Cls)

Nonrecourse purchase money debt that does not reasonably approximate the FMV of the underlying property is disregarded in its entirety for income tax purposes, rather than just disregarding it only to the extent the debt exceeds the value of the property. Thus, the court took a position contrary to the Third Circuit in *Pleasant Summit*, 863 F.2d 263, 63 AFTR 2d 89-344, 88-2 USTC ¶9601 (3rd Cir.).

Lukens v. Comm'r., 945 F.2d 92, 68 AFTR 2d 91-5754, 91-2 USTC ¶50517 (5th Cir.)

“The tax court completely disallowed Lukens' interest deductions after finding that the nonrecourse notes lacked economic substance. ... Lukens contends that the tax court erred as a matter of law because it failed to allow an interest deduction to the extent of the value of the timeshare units under the reasoning of *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3d Cir. 1988), cert. denied, ___ U.S. ___, 110 S. Ct. 260, 107 L.Ed.2d 210 (1989). We disagree.

... Section 163(a) of the Code provides for the deduction of "all interest paid or accrued within the taxable year on indebtedness." ... It is well settled that interest is deductible only if paid with respect to genuine indebtedness. ... Other courts of appeals have disallowed all interest deductions where the nonrecourse debt was found not to be genuine. See, e.g., *Lebowitz v. Commissioner*, 917 F.2d 1314, 1318-19 (2d Cir. 1990) (disagreeing with the holding of *Pleasant Summit*); *Odend'hal v. Commissioner*, 748 F.2d 908, 912 (4th Cir. 1984), cert. denied, 471 U.S. 1143, 105 S. Ct. 3552, 86 L.Ed. 2d 706 (1985); *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1049 (9th Cir. 1976). As the Ninth Circuit explained,

[t]o justify the deduction the debt must exist; potential existence will not do. For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price.

Estate of Franklin, 544 F.2d at 1049. In transactions where the amount of nonrecourse debt bears no reasonable relationship to the value of the collateral securing repayment of the debt, it is very unlikely that the obligation will ever be paid. The debtor has no economic incentive to satisfy the obligation when the only consequence of his default is forfeiture of collateral worth far less than the amount of nonrecourse debt. ... Several courts have held that such indebtedness should not be recognized because of the unlikelihood of payment of the obligation. ...

In *Pleasant Summit*, which *Lukens* would have us follow, the Third Circuit disagreed with the reasoning of *Estate of Franklin*. The court in *Pleasant Summit* noted that while a taxpayer holding property subject to a nonrecourse debt in excess of the market value of the property may have no incentive to pay off any portion of the debt, "it is equally logical to recognize that the creditor holding the debt has no incentive to take back the property if the taxpayer offers to pay the debt up to the value of the property." 863 F.2d at 276. For example,

if a creditor held a nonrecourse debt for \$1,500,000 on a property with a fair market value of \$1,000,000, he would have a disincentive to foreclose if his defaulting debtor offered to settle the debt for not less than \$1,000,000. Thus, it is appropriate to disregard only the portion of nonrecourse debt in excess of the fair market value of the property when it was acquired for purposes of calculations of the depreciation and interest deductions and to regard the nonrecourse debt as genuine indebtedness to the extent it is not disregarded.

Id. at 276-77.

Even if we were to accept the reasoning in *Pleasant Summit*, it would be relevant only to certain debtor-creditor relationships. For example, a creditor holding a nonrecourse loan secured by an apartment building, who has no wish to manage or maintain the collateral, has clear incentive to settle the debt at its market value in order to avoid the consequences of foreclosing on the collateral. Likewise, the debtor holding such collateral has incentive to make a compromise settlement of the debt up to the value of the collateral in order to keep the property. The reasoning in *Pleasant Summit*, however, would not help *Lukens* in the instant case. The time-share units, especially following the amendment turning the interests in the units from tenancies-in-common into licenses, see *supra* note 2, are of dubious utility. The inflated payments made by *Lukens* purchased, in essence, an opportunity to take disproportionately large tax deductions. The analysis undertaken by the Third Circuit in *Pleasant Summit* is of doubtful relevance when dealing with collateral like that at issue here.

We therefore reject *Lukens*' invitation to embark on the course set by *Pleasant Summit*, and prefer instead to embrace the position of the Ninth Circuit in *Estate of Franklin*, which has been accepted by the Second and Fourth Circuits. The proper inquiry in this situation, as recognized in *Estate of Franklin*, is not whether the seller/creditor has an incentive to settle the debt at the fair market value of the collateral, but whether it would be reasonable for the buyer/debtor to make a capital investment in the unpaid purchase price. ...

We agree with the tax court that *Lukens* has no incentive ever to pay the obligation. ...

...

We agree with the tax court that the nonrecourse debt lacks economic substance, and that any interest deduction thereon should be disallowed completely."

Rev. Rul. 82-224

Similar to the cases above, Taxpayer was only allowed to determine his basis in property by reference to the cash paid and the principal portion of a recourse debt. Taxpayer was not allowed to include a nonrecourse debt in basis because it exceeded the property's FMV. In the ruling, the IRS refers to the taxpayer's "initial" basis in the property.

QUERY: Is the IRS's reference to "initial" basis infer that if payments are made on the nonrecourse debt, they will increase taxpayer's basis at that time? How would depreciation be calculated? Do the rules on contingent liabilities apply in this context?

Improvements, Basis and Cash Method Taxpayers

Owen v. U.S., 83 AFTR2d 99-1555 (DC TN) – The court ruled that a cash method taxpayer could not increase its basis in real property for improvements made that were paid for with a promissory note. While the promissory notes were made to an entity controlled by one of the taxpayers, this was not a justification for the court’s decision. The court distinguished between acquiring property using debt versus making improvements with debt. The court stated that to allow basis to be increased would violate the fundamental principle that cash method taxpayers may not recognize income or expenses until an expenditure is made. The cash method taxpayer should not be allowed to obtain depreciation deductions prior to making a cash outlay. “To hold otherwise would also remove any distinction between cash and accrual basis taxpayers when dealing with capital expenditures, a result for which the court finds no authority within the [Code].”

QUERY: Should the amount of the nonrecourse debt that does not exceed the property’s basis be included in depreciable basis? What is the relevance of the taxpayer’s incentive to pay the debt?

Old and New Rules on Reporting by Brokers

As modified by the Emergency Economic Stabilization Act of 2008
(PL 110-343, 10/3/08)

§6045 Returns of brokers [(g) and (h) are effective 1/1/11]

- (a) General rule. Every person doing business as a broker shall, when required by the Secretary, make a return, in accordance with such regulations as the Secretary may prescribe, showing the name and address of each customer, with such details regarding gross proceeds and such other information as the Secretary may by forms or regulations require with respect to such business.
- (b) Statements to be furnished to customers. Every person required to make a return under subsection (a) shall furnish to each customer whose name is required to be set forth in such return a written statement showing—
- (1) the name, address, and phone number of the information contact of the person required to make such return, and
 - (2) the information required to be shown on such return with respect to such customer.

The written statement required under the preceding sentence shall be furnished to the customer on or before February 15 of the year following the calendar year for which the return under subsection (a) was required to be made. In the case of a consolidated reporting statement (as defined in regulations) with respect to any customer, any statement which would otherwise be required to be furnished on or before January 31 of a calendar year with respect to any item reportable to the taxpayer shall instead be required to be furnished on or before February 15 of such calendar year if furnished with such consolidated reporting statement.

- (c) Definitions. For purposes of this section —
- (1) Broker. The term “broker” includes—
 - (A) a dealer,
 - (B) a barter exchange, and
 - (C) any other person who (for a consideration) regularly acts as a middleman with respect to property or services.

A person shall not be treated as a broker with respect to activities consisting of managing a farm on behalf of another person.
 - (2) Customer. The term “customer” means any person for whom the broker has transacted any business.
 - (3) Barter exchange. The term “barter exchange” means any organization of members providing property or services who jointly contract to trade or barter such property or services.
 - (4) Person. The term “person” includes any governmental unit and any agency or instrumentality thereof.
- (d) Statements required in case of certain substitute payments. If any broker—
- (1) transfers securities of a customer for use in a short sale or similar transaction, and
 - (2) receives (on behalf of the customer) a payment in lieu of—
 - (A) a dividend,
 - (B) tax-exempt interest, or

(C) such other items as the Secretary may prescribe by regulations,

during the period such short sale or similar transaction is open, the broker shall furnish such customer a written statement (in the manner as the Secretary shall prescribe by regulations) identifying such payment as being in lieu of the dividend, tax-exempt interest, or such other item. The written statement required under the preceding sentence shall be furnished on or before February 15 of the year following the calendar year in which the payment was made. The Secretary may prescribe regulations which require the broker to make a return which includes the information contained in such written statement.

(e) Return required in the case of real estate transactions.

- (1) In general. In the case of a real estate transaction, the real estate reporting person shall file a return under subsection (a) and a statement under subsection (b) with respect to such transaction.
- (2) Real estate reporting person. For purposes of this subsection, the term “real estate reporting person” means any of the following persons involved in a real estate transaction in the following order:
 - (A) the person (including any attorney or title company) responsible for closing the transaction,
 - (B) the mortgage lender,
 - (C) the seller's broker,
 - (D) the buyer's broker, or
 - (E) such other person designated in regulations prescribed by the Secretary.

Any person treated as a real estate reporting person under the preceding sentence shall be treated as a broker for purposes of subsection (c)(1).

- (3) Prohibition of separate charge for filing return. It shall be unlawful for any real estate reporting person to separately charge any customer for complying with any requirement of paragraph (1). Nothing in this paragraph shall be construed to prohibit the real estate reporting person from taking into account its cost of complying with such requirement in establishing its charge (other than a separate charge for complying with such requirement) to any customer for performing services in the case of a real estate transaction.
- (4) Additional information required. In the case of a real estate transaction involving a residence, the real estate reporting person shall include the following information on the return under subsection (a) and on the statement under subsection (b):
 - (A) The portion of any real property tax which is treated as a tax imposed on the purchaser by reason of section 164(d)(1)(B).
 - (B) Whether or not the financing (if any) of the seller was federally-subsidized indebtedness (as defined in section 143(m)(3)).
- (5) Exception for sales or exchanges of certain principal residences.
 - (A) In general. Paragraph (1) shall not apply to any sale or exchange of a residence for \$250,000 or less if the person referred to in paragraph (2) receives written assurance in a form acceptable to the Secretary from the seller that—
 - (i) such residence is the principal residence (within the meaning of section 121) of the seller,

(ii) if the Secretary requires the inclusion on the return under subsection (a) of information as to whether there is federally subsidized mortgage financing assistance with respect to the mortgage on residences, that there is no such assistance with respect to the mortgage on such residence, and

(iii) the full amount of the gain on such sale or exchange is excludable from gross income under section 121 .

If such assurance includes an assurance that the seller is married, the preceding sentence shall be applied by substituting “\$500,000” for “\$250,000”. The Secretary may by regulation increase the dollar amounts under this subparagraph if the Secretary determines that such an increase will not materially reduce revenues to the Treasury.

(B) Seller. For purposes of this paragraph, the term “seller” includes the person relinquishing the residence in an exchange.

(f) Return required in the case of payments to attorneys.

(1) In general. Any person engaged in a trade or business and making a payment (in the course of such trade or business) to which this subsection applies shall file a return under subsection (a) and a statement under subsection (b) with respect to such payment.

(2) Application of subsection.

(A) In general. This subsection shall apply to any payment to an attorney in connection with legal services (whether or not such services are performed for the payor).

(B) Exception. This subsection shall not apply to the portion of any payment which is required to be reported under section 6041(a) (or would be so required but for the dollar limitation contained therein) or section 6051.

(g) Additional information required in the case of securities transactions, etc.

(1) In general. If a broker is otherwise required to make a return under subsection (a) with respect to the gross proceeds of the sale of a covered security, the broker shall include in such return the information described in paragraph (2).

(2) Additional information required.

(A) In general. The information required under paragraph (1) to be shown on a return with respect to a covered security of a customer shall include the customer's adjusted basis in such security and whether any gain or loss with respect to such security is long-term or short-term (within the meaning of section 1222).

(B) Determination of adjusted basis. For purposes of subparagraph (A) —

(i) In general. The customer's adjusted basis shall be determined—

(I) in the case of any security (other than any stock for which an average basis method is permissible under section 1012), in accordance with the first-in first-out method unless the customer notifies the broker by means of making an adequate identification of the stock sold or transferred, and

(II) in the case of any stock for which an average basis method is permissible under section 1012 , in accordance with the broker's

default method unless the customer notifies the broker that he elects another acceptable method under section 1012 with respect to the account in which such stock is held.

- (ii) Exception for wash sales. Except as otherwise provided by the Secretary, the customer's adjusted basis shall be determined without regard to section 1091 (relating to loss from wash sales of stock or securities) unless the transactions occur in the same account with respect to identical securities.

(3) Covered security. For purposes of this subsection —

(A) In general. The term “covered security” means any specified security acquired on or after the applicable date if such security—

- (i) was acquired through a transaction in the account in which such security is held, or
- (ii) was transferred to such account from an account in which such security was a covered security, but only if the broker received a statement under section 6045A with respect to the transfer.

(B) Specified security. The term “specified security” means—

- (i) any share of stock in a corporation,
- (ii) any note, bond, debenture, or other evidence of indebtedness,
- (iii) any commodity, or contract or derivative with respect to such commodity, if the Secretary determines that adjusted basis reporting is appropriate for purposes of this subsection , and
- (iv) any other financial instrument with respect to which the Secretary determines that adjusted basis reporting is appropriate for purposes of this subsection .

(C) Applicable date. The term “applicable date” means—

- (i) January 1, 2011, in the case of any specified security which is stock in a corporation (other than any stock described in clause (ii)),
- (ii) January 1, 2012, in the case of any stock for which an average basis method is permissible under section 1012, and
- (iii) January 1, 2013, or such later date determined by the Secretary in the case of any other specified security.

(4) Treatment of S corporations. In the case of the sale of a covered security acquired by an S corporation (other than a financial institution) after December 31, 2011, such S corporation shall be treated in the same manner as a partnership for purposes of this section.

(5) Special rules for short sales. In the case of a short sale, reporting under this section shall be made for the year in which such sale is closed.

(h) Application to options on securities.

(1) Exercise of option. For purposes of this section, if a covered security is acquired or disposed of pursuant to the exercise of an option that was granted or acquired in the same account as the covered security, the amount received with respect to the grant or paid

with respect to the acquisition of such option shall be treated as an adjustment to gross proceeds or as an adjustment to basis, as the case may be.

- (2) Lapse or closing transaction. In the case of the lapse (or closing transaction (as defined in section 1234(b)(2)(A))) of an option on a specified security or the exercise of a cash-settled option on a specified security, reporting under subsections (a) and (g) with respect to such option shall be made for the calendar year which includes the date of such lapse, closing transaction, or exercise.
- (3) Prospective application. Paragraphs (1) and (2) shall not apply to any option which is granted or acquired before January 1, 2013.
- (4) Definitions. For purposes of this subsection, the terms “covered security” and “specified security” shall have the meanings given such terms in subsection (g)(3).

§6045A Information required in connection with transfers of covered securities to brokers [effective 1/1/11]

- (a) Furnishing of information. Every applicable person which transfers to a broker (as defined in section 6045(c)(1)) a security which is a covered security (as defined in section 6045(g)(3)) in the hands of such applicable person shall furnish to such broker a written statement in such manner and setting forth such information as the Secretary may by regulations prescribe for purposes of enabling such broker to meet the requirements of section 6045(g).
- (b) Applicable person. For purposes of subsection (a), the term “applicable person” means—
 - (1) any broker (as defined in section 6045(c)(1)), and
 - (2) any other person as provided by the Secretary in regulations.
- (c) Time for furnishing statement. Except as otherwise provided by the Secretary, any statement required by subsection (a) shall be furnished not later than 15 days after the date of the transfer described in such subsection.

§6045B Returns relating to actions affecting basis of specified securities [effective 1/1/11]

- (a) In general. According to the forms or regulations prescribed by the Secretary, any issuer of a specified security shall make a return setting forth—
 - (1) a description of any organizational action which affects the basis of such specified security of such issuer,
 - (2) the quantitative effect on the basis of such specified security resulting from such action, and
 - (3) such other information as the Secretary may prescribe.
- (b) Time for filing return. Any return required by subsection (a) shall be filed not later than the earlier of—
 - (1) 45 days after the date of the action described in subsection (a), or
 - (2) January 15 of the year following the calendar year during which such action occurred.
- (c) Statements to be furnished to holders of specified securities or their nominees. According to the forms or regulations prescribed by the Secretary, every person required to make a return under subsection (a) with respect to a specified security shall furnish to the nominee with respect to the specified security (or certificate holder if there is no nominee) a written statement showing—

- (1) the name, address, and phone number of the information contact of the person required to make such return,
- (2) the information required to be shown on such return with respect to such security, and
- (3) such other information as the Secretary may prescribe.

The written statement required under the preceding sentence shall be furnished to the holder on or before January 15 of the year following the calendar year during which the action described in subsection (a) occurred.

- (d) Specified security. For purposes of this section, the term “specified security” has the meaning given such term by section 6045(g)(3)(B). No return shall be required under this section with respect to actions described in subsection (a) with respect to a specified security which occur before the applicable date (as defined in section 6045(g)(3)(C)) with respect to such security.
- (e) Public reporting in lieu of return The Secretary may waive the requirements under subsections (a) and (c) with respect to a specified security, if the person required to make the return under subsection (a) makes publicly available, in such form and manner as the Secretary determines necessary to carry out the purposes of this section —
 - (1) the name, address, phone number, and email address of the information contact of such person, and
 - (2) the information described in paragraphs (1) , (2) , and (3) of subsection (a).

Legislative History to PL 110-343 Changes on Broker Reporting of Basis

Broker reporting of customer’s basis in securities transactions (sec. 403 of the bill and sec. 6045 and new secs. 6045A and 6045B of the Code)

Joint Committee on Taxation Report — JCX-75-08 (pg 132 – 138)

Present Law

In general

Gain or loss generally is recognized for Federal income tax purposes on realization of that gain or loss (for example, through the sale of property giving rise to the gain or loss). The taxpayer's gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis.²⁵² To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.²⁵³ The original basis of property is its cost, except as otherwise prescribed by the Code (for example, in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and generally is adjusted upward to reflect income and gain inclusions or capital outlays with respect to the property.

²⁵²Sec. 1001.

²⁵³ Sec. 1016.

Basis computation rules

If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the “first-in-first-out rule”).²⁵⁴ If a taxpayer makes an adequate identification of shares of stock

that it sells, the shares of stock treated as sold are the shares that have been identified.²⁵⁵ A taxpayer who owns shares in a regulated investment company (“RIC”) generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average-cost-basis methods described in Treasury regulations.²⁵⁶

²⁵⁴Treas. Reg. sec. 1.1012-1(c)(1).

²⁵⁵Treas. Reg. sec. 1.1012-1(c).

²⁵⁶Treas. Reg. sec. 1.1012-1(e).

Information reporting

Present law imposes information reporting requirements on participants in certain transactions. Under these requirements, information is generally reported to the IRS and furnished to taxpayers. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether taxpayers' tax returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of \$600 or more made in the course of the payor's trade or business.²⁵⁷

²⁵⁷Sec. 6041(a).

Section 6045(a) requires brokers to file with the IRS annual information returns showing the gross proceeds realized by customers from various sale transactions. The Secretary is authorized to require brokers to report additional information related to customers.²⁵⁸ Brokers are required to furnish to every customer information statements with the same gross proceeds information that is included in the returns filed with the IRS for that customer.²⁵⁹ These information statements are required to be furnished by January 31 of the year following the calendar year for which the return under section 6045(a) is required to be filed.²⁶⁰

²⁵⁸Sec. 6045(a).

²⁵⁹Sec. 6045(b).

²⁶⁰Id.

A person who is required to file information returns but who fails to do so by the due date for the returns, includes on the returns incorrect information, or files incomplete returns generally is subject to a penalty of \$50 for each return with respect to which such a failure occurs, up to a maximum of \$250,000 in any calendar year.²⁶¹ Similar penalties, with a \$100,000 calendar year maximum, apply to failures to furnish correct information statements to recipients of payments for which information reporting is required.²⁶²

²⁶¹Sec. 6721.

²⁶²Sec. 6722.

Present law does not require broker information reporting with respect to a customer's basis in property but does impose an obligation to keep records, as described below.

Basis recordkeeping requirements

Taxpayers are required to “keep such records ... as the Secretary may from time to time prescribe.”²⁶³ Treasury regulations impose recordkeeping requirements on any person required to file information returns.²⁶⁴

²⁶³Sec. 6001.

²⁶⁴Treas. Reg. sec. 1.6001-1(a).

Treasury regulations provide that donors and donees should keep records that are relevant in determining a donee's basis in property.²⁶⁵ IRS Publication 552 states that a taxpayer should keep

basis records for property until the period of limitations expires for the year in which the taxpayer disposes of the property.

²⁶⁵Treas. Reg. sec. 1.1015-1(g).

Explanation of Provision

In general

Under the provision, every broker that is required to file a return under section 6045(a) reporting the gross proceeds from the sale of a covered security must include in the return (1) the customer's adjusted basis in the security and (2) whether any gain or loss with respect to the security is long-term or short-term (within the meaning of section 1222).

Covered securities

A covered security is any specified security acquired on or after an applicable date if the security was (1) acquired through a transaction in the account in which the security is held or (2) was transferred to that account from an account in which the security was a covered security, but only if the transferee broker received a statement under section 6045A (described below) with respect to the transfer. Under this rule, certain securities acquired by gift or inheritance are not covered securities.

A specified security is any share of stock in a corporation (including stock of a regulated investment company); any note, bond, debenture, or other evidence of indebtedness; any commodity or a contract or a derivative with respect to the commodity if the Secretary determines that adjusted basis reporting is appropriate; and any other financial instrument with respect to which the Secretary determines that adjusted basis reporting is appropriate.

For stock in a corporation (other than stock for which an average basis method is permissible under section 1012), the applicable date is January 1, 2011. For any stock for which an average basis method is permissible under section 1012, the applicable date is January 1, 2012. Consequently, the applicable date for certain stock acquired through a periodic stock investment plan (for which stock additional rules are described below) and for stock in a regulated investment company is January 1, 2012. A regulated investment company is permitted to elect to treat as a covered security any stock in the company acquired before January 1, 2012. This election is described below. For any specified security other than stock in a corporation or stock for which an average basis method is permitted, the applicable date is January 1, 2013, or a later date determined by the Secretary.

Computation of adjusted basis

The customer's adjusted basis required to be reported to the IRS is determined under the following rules. The adjusted basis of any security other than stock for which an average basis method is permissible under section 1012 is determined under the first-in, first-out method unless the customer notifies the broker by means of making an adequate identification (under the rules of section 1012 for specific identification) of the stock sold or transferred. The adjusted basis of stock for which an average basis method is permissible under section 1012 is determined in accordance with the broker's default method under section 1012 (that is, the first-in, first-out method, the average cost method, or the specific identification method) unless the customer notifies the broker that the customer elects another permitted method. This notification is made separately for each account in which stock for which the average cost method is permissible is held and, once made, applies to all stock held in that account. As a result of this rule, a broker's basis computation method used for stock held in one account with that broker may differ from the basis computation method used for stock held in another account with that broker.

For any sale, exchange, or other disposition of a specified security after the applicable date (defined previously), the provision modifies section 1012 so that the conventions prescribed by regulations under that section for determining adjusted basis (the first-in, first-out, specific identification, and average basis conventions) apply on an account-by-account basis. Under this rule, for example, if a customer holds shares of the same specified security in accounts with different brokers, each broker makes its adjusted

basis determinations by reference only to the shares held in the account with that broker, and only shares in the account from which the sale is made may be identified as the shares sold. Unless the election described next applies, any stock for which an average basis method is permissible under section 1012 which is acquired before January 1, 2012 is treated as a separate account from any such stock acquired on or after that date. A consequence of this rule is that if adjusted basis is being determined using an average basis method, average basis is computed without regard to any stock acquired before January 1, 2012. A regulated investment company, however, may elect (at the time and in the form and manner prescribed by the Secretary), on a stockholder-by-stockholder basis, to treat as covered securities all stock in the company held by the stockholder without regard to when the stock was acquired. When this election applies, the average basis of a customer's regulated investment company stock is determined by taking into account shares of stock acquired before, on, and after January 1, 2012. A similar election is allowed for any broker holding stock in a regulated investment company as a nominee of the beneficial owner of the stock.

If stock is acquired on or after January 1, 2011 in connection with a periodic stock investment plan, the basis of that stock is determined under one of the basis computation methods permissible for stock in a regulated investment company. Accordingly, an average cost method may be used for determining the basis of stock acquired under a periodic stock investment plan. In determining basis under this rule, the account-by-account rules described previously, including the election available to regulated investment companies, apply. The special rule for stock acquired through a periodic stock investment plan, however, applies only while the stock is held as part of the plan. If stock to which this rule applies is transferred to another account, the stock will have a cost basis in that other account equal to its basis in the periodic stock investment plan immediately before the transfer (with any proper adjustment for charges incurred in connection with the transfer). After the transfer, however, the transferee broker may use the otherwise applicable convention (that is, the first-in, first-out method or the specific identification method) for determining which shares are sold when a sale is made of some but not all shares of a particular security. It is expected that when stock acquired through a periodic stock investment plan is transferred to another account, the broker executing the transfer will provide information necessary in applying an allowable convention for determining which shares are sold. Accordingly, the transferor broker will be expected to state that shares transferred have a long-term holding period or, for shares that have a short-term holding period, the dates on which the shares were acquired.

A periodic stock investment plan is any stock purchase plan and any dividend reinvestment plan. A stock purchase plan is any arrangement under which identical stock is periodically purchased pursuant to a written plan. A dividend reinvestment plan is any arrangement under which dividends on stock are reinvested in stock identical to the stock with respect to which the dividends are paid. Stock is treated as acquired in connection with a dividend reinvestment plan if the stock is acquired pursuant to the plan or if the dividends paid on the stock are subject to the plan.

Exception for wash sales

Unless the Secretary provides otherwise, a customer's adjusted basis in a covered security generally is determined without taking into account the effect on basis of the wash sale rules of section 1091. If, however, the acquisition and sale transactions resulting in a wash sale under section 1091 occur in the same account and are in identical securities, adjusted basis is determined by taking into account the effect of the wash sale rules. Securities are identical for this purpose only if they have the same Committee on Uniform Security Identification Procedures number.

Special rules for short sales

The provision provides that in the case of a short sale, gross proceeds and basis reporting under section 6045 generally is required in the year in which the short sale is closed (rather than, as under the present law rule for gross proceeds reporting, the year in which the short sale is entered into).

Reporting requirements for options

The provision generally eliminates the present-law regulatory exception from section 6045(a) reporting for certain options. If a covered security is acquired or disposed of by reason of the exercise of an option that was granted or acquired in the same account as the covered security, the amount of the premium received or paid with respect to the acquisition of the option is treated as an adjustment to the gross proceeds from the subsequent sale of the covered security or as an adjustment to the customer's adjusted basis in that security. Gross proceeds and basis reporting also is required when there is a lapse of, or a closing transaction with respect to, an option on a specified security or an exercise of a cash-settled option. Reporting is required for the calendar year that includes the date of the lapse, closing transaction, or exercise. For example, if a taxpayer acquires for \$5 a cash settlement stock option with a strike price of \$100 and settles the option when the stock trades at \$120, a broker through which the acquisition and cash settlement are executed is required to report gross proceeds of \$20 from the cash settlement and a basis in the option of \$5. For purposes of the reporting requirement for closing transactions, a closing transaction includes a mark-to-market under section 1256. It is intended that a specified security for purposes of the reporting rules described in this paragraph includes a stock index such as the S&P 500. The reporting rules related to options transactions apply only to options granted or acquired on or after January 1, 2013.

Treatment of S corporations

The provision provides that for purposes of section 6045, an S corporation (other than a financial institution) is treated in the same manner as a partnership. This rule applies to any sale of a covered security acquired by an S corporation (other than a financial institution) after December 31, 2011. When this rule takes effect, brokers generally will be required to report gross proceeds and basis information to customers that are S corporations.

Time for providing statements to customers

The provision changes to February 15 the present-law January 31 deadline for furnishing certain information statements to customers. The statements to which the new February 15 deadline applies are (1) statements showing gross proceeds (under section 6045(b)) or substitute payments (under section 6045(d)) and (2) statements with respect to reportable items (including, but not limited to, interest, dividends, and royalties) that are furnished with consolidated reporting statements (as defined in regulations). The term "consolidated reporting statement" is intended to refer to annual account information statements that brokerage firms customarily provide to their customers and that include tax-related information. It is intended that the February 15 deadline for consolidated reporting statements apply in the same manner to statements furnished for any account or accounts, taxable and retirement, held by a customer with a mutual fund or other broker.

Broker-to-broker and issuer reporting

Every broker (as defined in section 6045(c)(1)), and any other person specified in Treasury regulations, that transfers to a broker (as defined in section 6045(c)(1)) a security that is a covered security when held by that broker or other person must, under new section 6045A, furnish to the transferee broker a written statement that allows the transferee broker to satisfy the provision's basis and holding period reporting requirements. The Secretary may provide regulations that prescribe the content of this statement and the manner in which it must be furnished. It is contemplated that the Secretary will permit this broker-to-broker reporting requirement to be satisfied electronically rather than by paper. Unless the Secretary provides otherwise, the statement required by this rule must be furnished not later than 15 days after the date of the transfer of the covered security.

Present law penalties for failure to furnish correct payee statements apply to failures to furnish correct statements in connection with the transfer of covered securities.

New section 6045B requires, according to forms or regulations prescribed by the Secretary, any issuer of a specified security to file a return setting forth a description of any organizational action (such as a stock split or a merger or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by the Secretary. This return must

be filed within 45 days after the date of the organizational action or, if earlier, by January 15 of the year following the calendar year during which the action occurred. Every person required to file this return for a specified security also must furnish, according to forms or regulations prescribed by the Secretary, to the nominee with respect to that security (or to a certificate holder if there is no nominee) a written statement showing the name, address, and phone number of the information contact of the person required to file the return, the information required to be included on the return with respect to the security, and any other information required by the Secretary. This statement must be furnished to the nominee or certificate holder on or before January 15 of the year following the calendar year in which the organizational action took place. No return or information statement is required to be provided under new section 6045B for any action with respect to a specified security if the action occurs before the applicable date (as defined previously) for that security.

The Secretary may waive the return filing and information statement requirements if the person to which the requirements apply makes publicly available, in the form and manner determined by the Secretary, the name, address, phone number, and email address of the information contact of that person, and the information about the organizational action and its effect on basis otherwise required to be included in the return.

The present-law penalties for failure to file correct information returns apply to failures to file correct returns in connection with organizational actions. Similarly, the present-law penalties for failure to furnish correct payee statements apply to a failure under new section 6045B to furnish correct statements to nominees or holders or to provide required publicly available information in lieu of returns and written statements.

Effective Date

The provision generally takes effect on January 1, 2011. The change to February 15 of the present-law January 31 deadline for furnishing certain information statements to customers applies to statements required to be furnished after December 31, 2008.

IRS Issues Final Regulations on New Basis Reporting Requirement; For Investors, Reporting Gains and Losses Gets Easier Starting in 2011

IR-2010-104, Oct. 12, 2010

WASHINGTON — The Internal Revenue Service today issued final regulations under a law change that will require reporting of basis and other information by stock brokers and mutual fund companies for most stock purchased in 2011 and all stock purchased in 2012 and later years. The reporting will be to investors and the IRS.

This additional reporting will be optional for stock purchased prior to these dates.

“This important reporting change means investors will now receive the information they need to more easily and accurately report their gains and losses,” said IRS Commissioner Doug Shulman. “We will continue to work closely with stakeholder groups to ensure a smooth implementation of the new requirement, which reduces the recordkeeping and paperwork burden for millions of taxpayers.”

These regulations, posted today in the Federal Register, implement a provision in the Energy Improvement and Extension Act of 2008. Among other things, the regulations describe who is subject to this reporting requirement, which transactions are reportable and what information needs to be reported. Besides providing numerous examples, they also adopt a number of comments and

suggestions received since the proposed regulations were issued last December.

Form 1099-B, Proceeds from Broker and Barter Exchange Transactions, long used to report sales prices, will be expanded in 2011 to include the cost or other basis of stock and mutual fund shares sold or exchanged during the year. Stock brokers and mutual fund companies will use this form to make these expanded year-end reports.

The expanded form will also be used to report whether gain or loss realized on these transactions is long-term (held more than one year) or short-term (held one year or less), a key factor affecting the tax treatment of gain or loss. The expanded form, to be first used for calendar-year 2011 sales, must be filed with the IRS and furnished to investors in early 2012.

The IRS today also announced penalty relief for brokers and custodians for reporting certain transfers of stock in 2011.

The relief is described in Notice 2010-67.