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April 9, 2012

By Hand Delivery

Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Attention: CC:PA:LPD:PR (REG-168745-03)

Re: Comments on Temporary and Proposed Regulations -- Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property

Dear Sir:

We are writing to you on behalf of our law firm's clients in response to Notice of Proposed Rule Making REG-168745-03, requesting comments from interested parties regarding temporary and proposed regulations under sections 162, 168, and 263(a) of the Internal Revenue Code, concerning the distinction between deductible repairs and capital expenditures, as well as related subjects concerning the treatment of materials and supplies and the grouping and disposition of depreciable assets. By separate letter, we

are requesting an opportunity to testify at the public hearing to be held on these temporary and proposed regulations on May 9, 2012.

We represent a wide range of clients in the manufacturing, wholesale and retail, aerospace, and service industries, including certain regulated industries, whose interests would be significantly affected by the rules contained in these temporary and proposed regulations. Set forth below are our comments on various sections of the temporary and proposed regulations.

Our comments address the following principal subjects:

1. Overall Approach and Procedural Status of Regulations
2. Treatment of Spare Parts
3. "*De minimis*" or "Minimum Capital" Rule
4. Treatment of Repair Expenses in Conjunction with Casualty Loss
5. The Application of Restoration Rules to Replacement of Components of Property
6. New Disposition and Grouping Rules and Componentizing Property
7. Transition Rules

These areas are addressed in detail below.

1. Overall Approach and Procedural Status of Regulations

With respect to the overall approach adopted in these regulations, it is our view that these regulations are unduly complex, given that the final result in any given

transaction is still heavily dependent on the facts in each case. This is evidenced by the fact that in almost every example in these regulations, the final determination as to whether a particular expenditure must be capitalized or may instead be expensed turns on a factual finding that the regulations do not answer as to whether the expenditure either did or did not substantially enhance the value of the property being repaired, extend its useful life, or help to convert the property to a new and different use. Moreover, the rules that are adopted create numerous traps for the unwary, particularly for small taxpayers that do not have the benefit of sophisticated outside tax advisers.

In addition, the regulations are immediately effective because they have been designated as temporary and proposed, notwithstanding that many provisions in these regulations are entirely new and could not have been anticipated from prior versions of proposed regulations. Moreover, the regulations are, to a large extent, retroactive in requiring the application of IRC section 481(a). As a result, if any of the comments provided by commentators are accepted by the Treasury and Service and if the final regulations are not adopted until later next year, many taxpayers will need to make their second, and possibly their third, accounting method change in this same area within the short time span of three or four taxable years, depending on whether the taxpayer also filed a method change request under Rev. Proc. 2009-39.

With these overall observations as background, set forth below are our detailed comments.

2. Treatment of Certain Types of Spare Parts

One category of materials and supplies that was singled out for special treatment in the prior proposed regulations was rotable spare parts. This category of materials and supplies consists of replacement parts that are expected to be repaired by the taxpayer after the parts malfunction in a piece of machinery or equipment. Temporary spare parts are also included in this same special category of spare parts.

Under the prior proposed regulations, a taxpayer could elect to capitalize and depreciate rotable spare parts. However, if a taxpayer failed to make this election, and the taxpayer's rotable spare parts were accounted for as materials and supplies under Treas. Reg. § 1.162-3, rather than as depreciable property, the cost of the rotable spare parts could not be deducted until the spare parts were discarded by the taxpayer.

Since this treatment was not in accord with current law or current IRS policy (see Rev. Rul. 69-370, 1969-2 C.B. 34.), these temporary and proposed regulations permit a third alternative treatment for rotable spare parts. Under this third alternative (referred to as the "optional" method), rotable spare parts may be accounted for in the same manner as ordinary spare parts under Treas. Reg. § 1.162-3, which means that the cost of a rotable spare part may be deducted when the part is used or consumed in the repair of a unit of property. However, the fair market value of any part that is removed from the unit of property in the repair transaction and which is retained by the taxpayer for future use must be offset against the deduction for the cost of the replacement part.

This third alternative treatment is entirely in accord with current law, and the Treasury and Service are to be commended for including this alternative treatment in the temporary and proposed regulations. However, in the interests of avoiding needless complexity, it does not seem necessary to retain the method of deferring the deduction of the cost of the rotable spare part under Treas. Reg. § 1.162-3 until the part is discarded by the taxpayer.

It seems doubtful that any taxpayer will choose that alternative. Any taxpayer wishing to avoid the administrative difficulties of having to maintain records of identical spare parts with different cost bases will either elect to depreciate any rotable spare parts on hand or simply assume that the fair market value of the replaced part in a repair transaction involving a rotable spare part plus the subsequent cost to restore the damaged part to operational condition is equal to the cost of the replacement part.

Thus, for the sake of simplicity, the optional method of expensing the replacement part when it replaces a part in a unit of property, offset by the fair market value of the replaced part, should be recharacterized as the default method. The only alternative to this treatment should be the option to elect to depreciate rotable spare parts. The alternative of deduction upon abandonment of a rotable spare part is not necessary, the availability of this alternative adds undue complexity, and accordingly this alternative should be eliminated.

Finally, in our comments on the prior proposed regulations, we noted that there are a few other categories of spare parts aside from rotable spare parts that taxpayers sometimes elect to capitalize and depreciate. We expressed the concern that the capitalization/depreciation option in the prior proposed regulations was only extended to *rotable* spare parts.

We commend the Treasury and Service for addressing this problem in these temporary and proposed regulations by permitting a taxpayer to capitalize and depreciate any type of spare part, without regard to its status as rotable or as a standby emergency spare part. We believe that this approach will eliminate past uncertainties that existed with respect to whether a particular spare part was eligible for capitalization/depreciation treatment.

3. "*De minimis*" or "Minimum Capital" Rule

A. Scope of *De Minimis* Method

First, with respect to the nature and scope of the *de minimis* method, the temporary and proposed regulations do not take into account the fact that this "rule of administrative convenience" is not uniformly applied by taxpayers. While variations in the threshold level of expenditures to qualify for expense treatment are to be expected, there is in addition a lack of uniformity in how the method is applied in various situations by different taxpayers.

Some taxpayers use a *de minimis* method to avoid the need to track and depreciate the acquisition of low-cost units of property that the taxpayer would otherwise be required to capitalize and depreciate. For such taxpayers, the use of the *de minimis* method is confined to transactions where low-cost units of property are separately identified at the time of their acquisition and are immediately expensed.

However, even under this version of the *de minimis* method, some variation in practice occurs. Some taxpayers apply the *de minimis* threshold at the individual unit of property level and other taxpayers apply the *de minimis* threshold at the invoice level, so as to avoid accounting for multiple units acquired in a single acquisition.

More significantly, rather than using the foregoing type of *de minimis* approach that applies only to the acquisition of low-cost items of property, many taxpayers use a different type of *de minimis* method that avoids the need to inspect and analyze individual invoices. This alternative type of *de minimis* approach that is applied by many taxpayers does not differentiate between invoices that include charges only for the acquisition of low-cost items of property and invoices that contain only charges for repair services or that contain both charges for repair services and charges for low-cost property items.

With respect to this latter category of taxpayers, the preamble to the temporary and proposed regulations explicitly states that repair services and overhead costs may not be included in a taxpayer's *de minimis* method. However, as noted above, that is what many taxpayers now do. If the final regulations include an overall annual limitation on the

amount of a taxpayer's deductions under the *de minimis* method, and if taxpayers are able to extend that *de minimis* method to materials and supplies, as long as they stay within the annual limitation, it is not apparent that there is a policy reason why taxpayers should not be permitted to likewise include charges for repair services performed for them by contractors, as well as labor and overhead costs for work performed by the taxpayers' own employees, in their application of the *de minimis* method.

Accordingly, we urge that when the temporary and proposed regulations are adopted in final form, they explicitly permit the inclusion of repair labor and overhead costs in the *de minimis* method, provided the taxpayer's deductions do not exceed the annual ceiling on deductions.

Moreover, it is not clear what the exclusion of repair services from the *de minimis* approach means for taxpayers whose existing *de minimis* method does not conform to this exclusion. For example, it is not clear whether such taxpayers are required to change their current method of accounting in order to make use of the *de minimis* rule in the temporary regulations.

B. Computation and Amount of Annual Limitation

The proposed regulations provided a safe harbor test for determining whether a taxpayer's *de minimis* method clearly reflected its income. The temporary and proposed regulations replace the clear reflection requirement/safe harbor with an absolute annual ceiling on the amount of deductions that may be claimed under the *de minimis* method.

In light of this ceiling, we believe that it is unrealistic to expect that examining agents will permit taxpayers to continue using their existing *de minimis* methods, where the annual limitation on deductions in these temporary and proposed regulations is exceeded.

While we do not believe that an annual ceiling on the deduction is necessary or appropriate, we commend the Treasury and Service for increasing the limitation contained in the former safe harbor, although the safe harbor is now converted to a fixed limitation. The annual limitation on the deduction under the *de minimis* method is now the *greater,* rather than the *lesser*, of 0.1 percent of sales revenue computed for tax purposes or 5 percent of total depreciation claimed in a taxpayer's financial statements.

Nevertheless, a number of problems are raised by this new annual limitation on deductions under the *de minimis* method. One difficulty with the annual limitation in the temporary and proposed regulations is that many taxpayers now using a *de minimis* method do not segregate their invoices in accordance with whether the invoice was accounted for under the taxpayer's *de minimis* method.

Thus, there is not one place in a taxpayer's books and records where it may search in order to identify all of the invoices with amounts below the *de minimis* threshold. Second, even if a taxpayer could locate all such invoices, the taxpayer would have no way of knowing after the fact whether the department charged with recording the invoices employed the *de minimis* method to determine whether to expense the amount of the invoice or instead whether department personnel physically examined the invoice

because it contained amounts unrelated to the purchase of low-cost assets to determine the treatment of the invoice. Accordingly, it would not be easily determinable whether the taxpayer's *de minimis* method satisfies the annual limitation on deductions contained in the proposed and temporary regulations. In fact, most clients with whom we have discussed this issue have no idea whether the aggregate annual amount of deductions that they claimed under their *de minmis* method exceeded the limitation contained in the temporary and proposed regulations.

To avoid this problem in the future, such taxpayers will be required to develop a record-keeping mechanism in order to ascertain whether their deduction amount under the *de minimis* method is within the annual limitation in the regulations. In contrast, most taxpayers and their financial accountants measure materiality based on the cost threshold selected by the taxpayer for its *de minimis* method, rather than on the annual amount of deductions claimed under the method. Thus, the imposition of a separate, tax-only, materiality requirement based on the annual amount of the deduction seems unnecessary, as well as burdensome.

Apart from the absolute level of the annual deduction limitation, which we submit may still be too low to cover the *de minimis* method that many taxpayers currently employ, the bases used to compute the two factors making up the annual limitation on deductions under the *de minimis* method are impractical for several reasons. First, the

base for measuring the annual deduction limitation is not based on the cost threshold at which the *de minimis* method is set by a particular taxpayer.

The approach selected in the temporary regulations for computing the deduction limitation makes it very difficult for a taxpayer to determine the appropriate cost threshold at which to set the *de minimis* amount in order to stay within the annual deduction limitation in the regulations. For example, if the annual limitation on deductions is $10 million for a particular taxpayer, it is not very easy for a taxpayer to know what cost threshold to establish as its cut-off point for claiming deductions.

It would be preferable if the limitation on the amount of deductions allowed under the *de minimis* method were computed on a base that was directly related to the cost threshold itself, perhaps by using a relationship between the amount of a taxpayer's annual sales and the amount of the cost threshold per transaction. That would make it relatively easy for a taxpayer to determine what cost threshold to use before the start of the taxable year. As discussed below, no guidance is provided in the regulations as to what action a taxpayer should take when the taxpayer gets to the end of its taxable year and determines that its aggregate deduction under its *de minimis* method exceeds the annual limitation in the regulations. As it now stands, if a taxpayer wanted to reduce its cost threshold in an effort to remain under the regulatory limitation, the Service would likely regard such a change in the cost threshold as a change in method of accounting, necessitating the filing of a Form 3115. Tying the cost threshold directly to the base

could alleviate this administrative burden, because a Form 3115 would not be needed under such a regime.

Second, if this suggestion is rejected, at a minimum, it seems unduly complex and unnecessary to have one component of the limitation measured on a financial statement basis and a second component of the limitation measured on a tax basis. This use of divergent tax and a financial statement bases for computing the annual limitation also requires taxpayers to wait until after their tax return preparation process is far enough along to be able to calculate the amount of the limitation.

It would also be preferable if a taxpayer could know the amount of the annual limitation before a taxable year began, so that the taxpayer could adjust its *de minimis* cost threshold accordingly. For this reason, the annual limitation, at whatever level is set in the final regulations, should be based on the preceding year's sales revenue and/or depreciation expense. Moreover, both limitations should be calculated on the same basis, a tax basis. Such an approach would also alleviate the administrative burden that would result from a taxpayer discovering that its *de minimis* deductions exceeded the limitation in the temporary and proposed regulations.

Third, with respect to the amount of the annual deduction limitation, assuming the Treasury and Service feel compelled to retain an annual deduction limitation in the final regulations, notwithstanding the financial conformity requirement, we submit that the limitation should be increased to 0.5 percent of sales. We also suggest dropping the

depreciation alternative base for measuring the limitation because that base is unlikely to provide any additional limitation in the typical case.

Finally, as noted above, by establishing an annual limitation that is not based on the amount of the cost threshold under the taxpayer's *de minimis* method, the regulations will likely result in many taxpayers reaching the end of their taxable year and discovering that they have exceeded the annual deduction limitation in the regulations. The temporary and proposed regulations provide no guidance on what a taxpayer in such a position is supposed to do.

While the regulations offer taxpayers an asset by asset choice to elect out of the application of the *de minimis* method and capitalize the assets excluded from the *de minimis* method, that approach is not a particularly effective solution to the problem. For example, it might well be the case, based on the variation in *de minimis* methods now in use, that a portion of the excess deduction would be deductible without regard to the taxpayer's *de minimis* method.

As discussed above, the regulations were drafted with the premise that every dollar of cost to which a taxpayer's *de minimis* method is applied would otherwise be capitalized and depreciated. This premise is incorrect for many taxpayers. Accordingly, guidance needs to be provided in the regulations as to what action a taxpayer is supposed to take when the taxpayer reaches the end of a taxable year and determines that its cost threshold is set too high to comply with the annual limitation on the deduction, but all or

a portion of the excess amount that is deducted under the *de minimis* method would otherwise be deductible under a more direct application of sections 162 and 263(a).

In summary, of all of the sections in the temporary and proposed regulations, as currently drafted, the provisions governing the use of a *de minimis* method are most likely to present the greatest compliance problems for most taxpayers and to require the greatest number of changes from current practice. We submit that this subject should be reconsidered.

4. Treatment of Repair Expenses in Conjunction with Casualty Loss

The prior proposed regulations took the position that a taxpayer could not both deduct a loss resulting from a casualty event and also deduct the cost of repairs to restore the damaged property to its condition prior to the casualty. However, this position ignores the fact that the treatment of repair expenditures following a casualty very much depends on the extent and nature of the damage caused by the casualty.

To the extent the casualty event completely destroyed one or more entire units of a taxpayer's property, prevailing law required the cost of the replacement of the destroyed unit of property to be treated as a capital expenditure eligible for depreciation and the law permitted the taxpayer to deduct its remaining adjusted basis in the destroyed property resulting from disposition of the destroyed property. In contrast, where the casualty event merely damaged one or more of a taxpayer's units of property, without completely destroying the unit or units of property, the repair of such unit or units of property might

be deducted, in addition to deducting the casualty loss resulting from the diminution in the value of the taxpayer's property.

This result followed from the conclusion that the casualty event was separate from the subsequent decision to repair the damaged property. Moreover, the deduction of the repair expenses, as well as a deduction of the casualty loss, was not viewed as a double deduction of the repair expenses because the casualty loss regulations permit a taxpayer to use of the cost of the repairs as a surrogate for the measure of the diminution in the value of the existing property that was caused by the casualty event.

In the latter situation, we objected in our comments on the prior proposed regulations to the position adopted in those proposed regulations that a taxpayer could not deduct both the casualty loss and the cost of repairs to restore the damaged property to its condition prior to the casualty. In the preamble to these temporary and proposed regulations the Treasury and Service have explicitly rejected these comments.

However, there is one aspect of the rebuttal of the Treasury and the Service to these comments in the preamble to the temporary and proposed regulations that warrants a further response. This response is relevant to the Treasury's effort to ameliorate the inequity that resulted under the prior proposed regulations, where a business taxpayer suffering a casualty loss was required to claim the casualty loss, but as a result was required to capitalize the repair expenditures necessitated by the casualty event; these requirements had the effect of placing the taxpayer in a worse position than if the

taxpayer were not able to claim the casualty loss, but could then deduct the repair expenditures.

In our comments to the prior proposed regulations, we discussed at length the history of the casualty loss provisions and noted that the statutory provisions under the predecessors to section 165 were mainly directed at individuals. The extension of those rules to business taxpayers did not occur through legislation, but rather occurred through regulations promulgated by the Treasury. However, we reasoned that by virtue of several subsequent reenactments of the casualty loss provisions in the Internal Revenue Code after the initial regulatory extension of the casualty loss provisions to business taxpayers, Congress is presumed to have blessed these regulations through the "legislative reenactment" doctrine.

In response to this line of argument, the preamble to the temporary and proposed regulations contends that Congress could not have intended to reenact the Treasury's regulations with the effect claimed in our comments (*i.e.*, a deduction both of a casualty loss and the deduction of subsequent repair expenses) because that would have resulted in treating business taxpayers more favorably than individuals in the partial damage/ casualty loss situation (*i.e.*, both parties deduct the casualty loss, but only business taxpayers are permitted to deduct the subsequent repair expenditures). However, that analysis overlooks the disparity in the treatment of individuals and business taxpayers

that previously existed with respect to the deduction of a casualty loss before the legislative enactment of casualty loss provisions for individuals.

As noted in our prior comments, a casualty loss for non-business property held by an individual was not deductible apart from the special casualty loss rule enacted in the predecessor to section 165 because individuals are not entitled to deduct a loss with respect to personal-use property. In contrast, a casualty loss resulting from the complete destruction of a unit of property owned by a business taxpayer would have been deductible without regard to section 165 and its predecessors (and the regulations thereunder) because the complete destruction of a unit of business property would be a closed and completed transaction and would be considered a disposition of the destroyed property.

In this regard, we note the confirmation of this conclusion in the definition of a "disposition" of property that has long been provided in the regulations governing general asset accounts. Treas. Reg. § 1.168(i)-1(e). This provision defines a disposition of property as including the "destruction" of the property. This same definition is continued in the temporary and proposed regulations at Temp. Treas. Reg. § 1.168(i)-8T(b)(1). Moreover, apart from property grouped in a general asset account, in the case of the complete destruction of business property, the fact that the loss occurred by reason of a casualty event would be irrelevant – the loss would simply be deductible as a loss with respect to business-use property, regardless of the existence or application of section 165.

Accordingly, section 165 and its predecessors were, and continue to be, unnecessary in the case of a business taxpayer, where an entire unit of property is completely destroyed as a result of a casualty event. These provisions would only have relevance for a business taxpayer in a context where the business property was damaged by the casualty event, but not completely destroyed. In that circumstance, there would not be a disposition of the property damaged by the casualty event and, absent section 165 and its predecessors (and the extension of those sections to business taxpayers through regulations), the casualty loss would not be deductible by either a business or an individual taxpayer.

While Congress may not have been aware of that distinction between business taxpayers and individuals when the predecessors of section 165 were originally enacted, particularly since the predecessors to section 165 were originally directed only at individuals, surely the Treasury would be presumed to have understood that distinction. Thus, the only reasonable interpretation of the Treasury's original decision to extend a statutory provision relating to casualty losses that was directed exclusively at individuals to include its application to business taxpayers is that the Treasury intended to confer a benefit on business taxpayers that they did not already have – the ability to deduct a casualty loss in a situation where there was not a disposition of the damaged property, *i.e.*, partial damage to, but not complete destruction of, a unit of property.

However, these temporary and proposed regulations interpret the prior regulations as mandating that a business taxpayer claim a casualty loss for partial damage to property, but then capitalize the cost of repairing the damaged property. It seems unlikely that the Treasury's prior decision to extend through regulations the predecessors of section 165 to business taxpayers as an effort on the part of the Treasury to *punish* business taxpayers for suffering a casualty event by requiring business taxpayers to claim a loss as a result of the damage caused by the casualty event, but at the same time requiring the business taxpayer to capitalize the cost of repairing the damage caused by the casualty event that would otherwise have been a deductible repair expense. The punishment results from the fact that the capitalized repair expenditure must be depreciated over a new recovery period, whereas the remaining adjusted basis of the damaged property would have been deductible over its remaining recovery period.

Thus, the better interpretation of the Treasury's extension of the casualty loss statutory provisions for individuals to business taxpayers through the Treasury's prior regulations was to extend a benefit to business taxpayers, not punish them. Accordingly, knowledge of that intent would be presumed to have been understood by Congress when it repeatedly reenacted section 165 and its predecessors through subsequent codifications of the tax law.

Moreover, the Treasury's attempted solution to the problem that taxpayers are sometimes treated worse by being required to deduct the casualty loss does not solve the

problem. The approach adopted in the temporary and proposed regulations confers on taxpayers electing to use general asset accounts the ability to apply the default rule for dispositions from a general asset account, which rule provides that a loss on the disposition of property from a general asset account is ordinarily not recognized until the last unit of property in that account is retired. In addition, this election applies not only to a disposition of an entire unit of property, but also to a disposition of components of a unit of property that are either required to be treated as separate units of property (in the case of buildings) or that the taxpayer consistently elects to treat as separate units of property for disposition purposes (in the case of property other than buildings).

The problem with these changes to the regulations is that they are directed at modifying the rules for dispositions of property, whereas the partial damage of property is not a *disposition* of property. As noted above, according to the Treasury's own temporary regulations, only the complete destruction of property constitutes a *disposition* of property. The retention of property with the intention of repairing and reusing the property is neither a retirement, nor a disposition, of the property.

Moreover, it would be difficult for the Treasury and Service to sustain the position that there is a constructive disposition of the damaged portion of the property by reason of the reduction in the adjusted basis of the property that is required when a casualty loss is deducted. Treas. Reg. § 165-7 clearly indicates that the measure of the casualty loss is the diminution in the value of the property caused by the casualty event; the reduction in

the basis of the repaired property is not the rationale for claiming the loss from the casualty event, but rather is a limitation on the amount of the allowable loss. See Treas. Reg. § 1.165-7(a)(2)(ii).

Moreover, componentization of units of property does not eliminate the problem because many repairs to damaged property involve expenditures that do not involve the replacement of components of a unit of property. For example, following a storm, a public utility might expend considerable sums on reattaching downed wires and straightening bent poles. Those expenditures do not represent replacements of components of units of property.

Accordingly, the Treasury's approach does not achieve its intended goal. The approach in the temporary and proposed regulations fails to work in the situation where it is most needed, *i.e.*, where a taxpayer suffers only partial damage to property and the taxpayer intends to repair the damaged property, rather than retire or dispose of the damaged property.

Instead, in our view, the Treasury and Service need to modify the casualty loss regulations under section 165, to give business taxpayers the option not to claim a section 165 loss in a situation where a unit of property is damaged, but not completely destroyed. That type of approach would eliminate the unfair treatment of business taxpayers in the context of a partial casualty.

The alternative approach of using the disposition rules to alleviate the problem does not seem appropriate, given that the problem exists only in the case where there is not a disposition of the damaged property. In addition, using the disposition rules to cure the problem forces taxpayers to place every type of asset that could conceivably be damaged by a casualty loss into a general asset account. Many taxpayers may not wish to group property other than buildings in a general asset account.

One possible response to the suggestion that Treas. Reg. § 1.165-7 needs to be made optional for business taxpayers is that the Treasury and Service lack the authority to make such a sweeping change in the section 165 regulations. However, based on the argument in the preamble to the temporary and proposed regulations -- that the statutory provisions in section 165 only apply to individuals and it was only through the exercise of the Treasury's and Service's discretion that these rules were originally extended to business taxpayers -- the Treasury and Service would have the authority to retract that extension of the casualty loss rules to business taxpayers in the one situation where it produces the unintended effect of penalizing business taxpayers for suffering a casualty loss.

5. The Application of Restoration Rules to Replacements of Components of Property

Under the prior version of the proposed regulations, a restoration of a unit of property was required to be treated as a capital expenditure. One of the main categories

of repair transactions that constituted a restoration of property for purposes of this rule was the replacement of a major component or substantial structural part of a unit of property. While this rule in the prior proposed regulations would have replaced the current facts and circumstances approach that applies to such replacements, the application of the rule in the prior proposed regulations was tempered considerably by the fact that the rule only applied where the replacement occurred after the expiration of the recovery period of the unit of property. In addition, a major component or substantial structural part of a unit of property was defined in the prior proposed regulations as a part or component the original cost of which equaled or exceeded 50 percent of the original cost of the unit of property.

The substantial component replacement rules in the prior proposed regulations applied without regard to whether the general improvement rules would otherwise have resulted in capitalization of replacement parts or components of a unit of property. However, even if the replacement parts or components did not satisfy the foregoing requirements, the replacement parts or components might nonetheless be required to be capitalized if the general improvement rules were satisfied.

In these temporary and proposed regulations, the Treasury and Service have retained the provision that treats the replacement of a major part or substantial structural component of a unit of property as a capital expenditure, but the 50-percent test and the recovery period limitation in the prior proposed regulations have been eliminated. As a

result, all replacements of a major part or substantial structural component of a unit of property *must* be capitalized, without regard to the timing of the replacement and without the application of a numerical standard for measuring whether a part is *major* or a component of a unit of property is *substantial.*

We respectfully submit that with these two changes, the substantial replacement rule has become too rigid in comparison to the current state of the law. Unless a replacement of a part or component of a unit of property improves the unit of property, extends its useful life or qualifies the property for a new and different use, we do not view the case law as imposing an absolute rule requiring capitalization.

Assuming that the replacement of a major part or substantial structural component of a unit of property does not qualitatively improve the unit of property or convert the property to a new and different use, the replacement must otherwise extend the useful life of the unit of property in order to be classified as a capital expenditure. There ought not be an independent basis for capitalization apart from the normal three-prong test.

For example, it could well be the case that the recovery period for a particular class of property under MACRS was established based on the expected technological obsolescence of the class of property. In that circumstance, the mere fact that a major component of the unit of property malfunctions and is replaced does not mean that the unit of property has been improved or that the unit of property will be operable for any longer period than was originally intended or expected.

Instead, such factors as the point in time during the property's recovery period when the replacement occurs and the reason for the replacement would be considerations that affect the resolution of the capitalization-versus-expense issue. That determination should not depend solely on the magnitude of the replacement part or component.

The other problem with the new restoration rule for replacements is that it substitutes the issue of what constitutes a *major* part or *substantial* structural component of a unit of property for the issue that mainly confronted taxpayers in the past. We believe that the issue that generated so much controversy in the past, which is what is a unit of property, will largely be eliminated thanks to these temporary and proposed regulations. However, with no quantitative guidance as to the meaning of *major* parts or *substantial* structural components in the temporary and proposed regulations, we fear that much of the certainty achieved by these temporary and proposed regulations with respect to the definition of a unit of property will be lost.

Moreover, the uncertainty engendered by the proposed rule will place undue tension on a taxpayer's decision to elect to componentize its units of property, so as to avoid missing the opportunity to recover the adjusted basis of parts or components that have been replaced. Without any guidance on what constitutes a major part or substantial structural component of a unit of property, taxpayers will be hesitant to elect componentization of their units of property for fear of causing a replacement of a part or

component to be capitalized in a repair transaction that would otherwise have been deductible.

Accordingly, we recommend that the former 50-percent test (or perhaps a somewhat lower threshold) be reinstated in the final regulations, but it should be made clear that replacements of parts and components of a unit of property costing less than whatever is the threshold test still might be required to be capitalized under the improvement and betterment sections of the regulations.

6. New Disposition and Grouping Rules and the Componentization of Property

A. Introduction

Neither current law, nor the two prior sets of proposed regulations, provides any special disposition rules for parts and components of a unit of property. Moreover, neither of the prior versions of the proposed regulations contained any changes to the regulations under section 168.

Accordingly, in general, if a taxpayer replaced a part or component of a unit of property incident to a repair transaction, the taxpayer could not deduct the remaining adjusted basis of the replaced part or component, regardless of whether the replacement transaction was required to be capitalized. Under current law, the only situation in which the adjusted basis of a replaced part or component could be deducted upon its replacement is a situation where the replaced part or component itself is treated as a separate unit of property.

The temporary and proposed regulations change these rules in significant ways. While the preamble to the temporary and proposed regulations characterizes these changes as mainly taxpayer-favorable because these provisions permit a taxpayer to deduct the remaining adjusted basis of a part or component of a unit of property that is replaced, one of the taxpayer-unfavorable consequences of that new provision is that if a taxpayer deducts the remaining adjusted basis of a replaced part or component of a unit of property, the taxpayer *must* capitalize the cost of the replacement component under the restoration section of the temporary and proposed regulations.

While the foregoing consequence is not unfavorable to taxpayers in those instances in which the replacement transaction would otherwise be capitalized as either a betterment of the unit of property or because the replaced part is a major part or significant component of the unit of property, if the taxpayer could otherwise have deducted the cost of the replacement part or component, an election to claim a loss for the adjusted basis of the replaced part or component would not be to a taxpayer's benefit. Even more troubling is the fact that while this "componentization" of units of property is elective in the case of property other than buildings, such componentization is mandatory in the case of buildings and building systems.

B. Comments on Overall Approach Adopted in Temporary and Proposed Regulations

Before commenting on the details of the disposition and grouping provisions in the temporary and proposed regulations, some comments about the overall approach adopted in these regulations is warranted. First, the selection of the depreciation grouping sections of the regulations to introduce the concept of componentization and its relationship to dispositions of components of a unit of property makes the regulations difficult for many taxpayers to understand. Because many taxpayers have never used the various depreciation grouping conventions, but instead have generally used item accounts and, thus, have depreciated each unit of property separately, taxpayers may pay minimal attention to the depreciation grouping provisions in the temporary and proposed regulations without realizing their true import.

Second, neither in the preamble nor in the body of the temporary and proposed regulations dealing with depreciation grouping principles is there a clear explanation that the disposition rules may override the definition of a unit of property established in the improvement section of the regulations. For example, none of the examples dealing with the disposition of components of a unit of property mention that the consequence of recognizing the loss on the disposition of a component automatically requires the capitalization of the replacement component. The interplay between the restoration and depreciation grouping sections of the regulations is not emphasized, except in the two

new revenue procedures that the Service issued to deal with repairs accounting method changes.

Third, while the temporary and proposed regulations offer taxpayers the opportunity to deduct the adjusted basis of replaced parts or components of a unit of property when the replacement parts or components are capitalized and this is a fair and reasonable result, the approach that the Treasury and Service have selected to achieve this result is unduly complicated and will pose an administrative burden for many taxpayers. This complexity is created by the fact that taxpayers are required to claim the deduction for the adjusted basis of parts and components of a unit of property that are replaced before a taxpayer knows for sure whether the replacement transaction would otherwise be capitalized.

For example, in the case of property other than buildings, a taxpayer must elect to treat parts and/or components of a unit of property as separate assets for disposition purposes when the property is first placed in service and follow such componentization consistently over the recovery period of the property, rather than be able to wait until a replacement transaction occurs and the taxpayer has a better idea, although not necessarily absolute assurance, whether the replacement part or component must be capitalized. This uncertainty exists because all of the quantitative tests for determining when a replacement part or component is deemed major or significant for purposes of the restoration rules have been eliminated from the temporary and proposed regulations and

no other guidance is provided in the regulations as to whether a replacement part or component of a unit of property is major or significant and, thus, must be capitalized.

Moreover, even if a taxpayer elects to use general asset accounts to group its properties and thus is able to wait until a replacement transaction occurs before deciding whether to recognize a loss with respect to the replaced part or component, the taxpayer will still not know for sure whether the replacement transaction must be capitalized if the disposition loss were not recognized. That certainty can only come after the taxpayer is audited.

For example, without that certainty, how can a taxpayer decide whether to componentize its air conditioning system down to the level of the compressor or any other part or combination of parts or components within the air conditioning system? There are far too many types of property where it is unclear whether a part or component would be considered major or substantial.

Finally, as noted above, the disposition rules in the temporary and proposed regulations are inconsistent with the improvement rules in the regulations and divert attention away from the issue of the definition of a unit of property to the issue of the definition of a "major" part or "significant" component of a unit of property. Because of the disposition and restoration rules in the temporary and proposed regulations, audits will shift their focus from what is a unit of property to what is a major part or significant structural component of a unit of property, a much more nebulous issue that will be

difficult to resolve. We do not believe that this result would represent an improvement in the search for certainty of outcome and the minimization of controversies.

All of these problems could have been avoided if the temporary and proposed regulations had adopted the approach that whenever a taxpayer is required to capitalize a replacement part or component of a unit of property for whatever reason, and at whatever the point in time in the tax administration process that occurs, the taxpayer is entitled to claim an offsetting deduction for the adjusted basis of the replaced part or component, if the taxpayer so desires. This alternative approach does not, in our view, eliminate the need for the regulations to provide more guidance on when a replacement part or component of a unit of property must be capitalized because the part or component is major or significant. However, in no event should a taxpayer be penalized for mistakenly failing to claim the loss on the disposition of the replacement part or component of the unit of property at the time the property is placed in service (*i.e.,* no general asset accounts maintained), or at time the tax return is filed (*i.e.,* general asset accounts maintained).

It is true that a taxpayer obtains more flexibility in making these decisions if the taxpayer elects to place its units of property in one or more general asset accounts. However, general asset accounts are not a complete response to these problems. Even using a general asset account, a taxpayer must still decide whether to claim a loss on the

disposition of the replaced part or component in the tax return for the taxable year in which the part or component is replaced.

Under the temporary regulations, it does not appear that a taxpayer may claim a deduction for the replacement part or component of the unit of property and, if the Service capitalizes the replacement part or component on audit, the taxpayer may claim the loss on the disposition of the replaced part or component as an offset to the Service's audit adjustment. Since the default rule for general asset accounts continues to be the rule that no losses are recognized on dispositions of property from general asset accounts until the last unit of property or components thereof is retired, a taxpayer must affirmatively elect the disposition loss on a part or component at the time the part or component is replaced.

Nevertheless, even if the Treasury and Service reject our suggestion to allow greater flexibility on the time for claiming a disposition loss for parts and components of a unit of property, it is difficult to understand the need for taxpayers to employ general asset accounts in order to obtain whatever flexibility is provided in the temporary regulations. Once the general asset account rules are modified in the fashion contemplated in the temporary regulations, they begin to resemble item accounts.

Accordingly, instead of giving an advantage to general asset accounts, we respectfully suggest that taxpayers be given the choice of deducting or declining to

deduct disposition losses for parts or components of a unit of property without regard to how the property is grouped for depreciation purposes.

C. Exclusion of Certain Property from Permissive Componentization.

Treas. Reg. §§ 1.168(i)-1T(e)(2)(viii)(B)(4) and 1.168(i)-8T(c)(4)(ii)(D) provide that items included in asset classes 00.11 through 00.4 of Rev. Proc. 87-56 and property included in section 168(e)(3) (other than buildings and their structural components) are not eligible for componentization for disposition purposes. These asset classes cover a number of important types of property employed by most taxpayers, such as office furniture, computers, copiers and motor vehicles (other than those owned by transportation companies) and electric generation and distribution equipment (other than those producing electricity for sale to customers). See Treas. Reg. § 1.168(i)-8T(h) *Example 4*.

The preamble to the regulations offers no explanation as to why these asset classes are singled out for more stringent treatment. These types of asset classes are as likely to experience replacements of components that must be capitalized as a restoration of a unit of property as the balance of the asset classes that are eligible for componentization. We respectfully submit that consideration be given to making all of the foregoing excluded asset classes eligible for componentization in the final regulations, particularly those asset classes that include larger items, such as airplanes and electric generation and distribution equipment.

7. Transition Rules

The prior proposed regulations did not contain transition rules and the Treasury and Service received numerous comments from taxpayers and various taxpayer groups addressing the question of whether the transition rules in the final regulations should be cut-off transition rules or a section 481(a) adjustment. While many taxpayers suggested an option, the temporary regulations reject that alternative and require a section 481(a) adjustment, except in a few limited instances.

We submit that one additional section that should have contained a cut-off transition rule, in lieu of a section 481(a) adjustment, is the treatment of repairs following the claiming of a casualty loss. As noted earlier in these comments, the temporary regulations reject the notion that a taxpayer may claim both a casualty loss and a deduction for subsequent repairs to restore the damaged property to its prior condition. While the preamble explains the legal basis for the provisions in the temporary regulations, the preamble does not address the practice in the Field with respect to the deduction of both a casualty loss and a subsequent repair deduction.

In fact, in practice, the Service has permitted taxpayers to claim both a casualty loss and a repair deduction. Moreover, this treatment is not the result of a lack of audit detection. Many of these settlements are reflected in closing agreements entered into by taxpayers and the Service.

We submit that it is unfair to require a section 481(a) adjustment transition rule in these circumstances. First, in many cases, a taxpayer settled the casualty loss issue by trading away other unrelated issues in the audit that were not accounting methods and, therefore, cannot at this time be recouped by a taxpayer if the taxpayer is forced to concede the casualty loss issue.

Second, casualty losses tend to be isolated transactions, rather than repetitive transactions of the type to which the accounting method change rules apply. In the case of repetitive transactions, the application of section 481(a) tends to be beneficial to taxpayers because of the four-year spread of the resulting section 481(a) adjustment, whereas the application of a cut-off transition rule to such repetitive transactions merely postpones the effect of the new method of accounting by just one taxable year.

That would not be true in the case of casualty losses. Treating the casualty loss as an accounting method and subjecting it to a section 481(a) adjustment is more akin to making the new regulations retroactive, but without charging interest on the prior years' deductions.

While the Treasury and Service believe that the regulations' treatment of casualty losses is consistent with current law, in fact that is not the way the Service settled many cases on this issue in the past. Accordingly, the Treasury and Service might consider limiting cut-off relief to situations where the Service actually agreed with the casualty loss/repair deductions. To adopt such an approach, the Treasury and Service could

provide that in order to be entitled to cut-off transitions relief, a taxpayer must submit affirmative evidence (such as a closing agreement or Form 870-AD) prior to claiming cut-off transition relief.

One additional issue that needs to be addressed in the transition rules in the temporary and proposed regulations is the relationship between these transition rules and the section 446 final regulations that deal with changes in method of accounting for depreciation. There appears to be an inconsistency between the transition rules in these two sets of regulations relating to the scope of the *item* that is the subject of the method change.

In 2003, when the depreciation method change rules were revised and moved to Treas. Reg. § 1.446-1(e)(2)(ii)(d), a new provision was inserted in the section 446 regulations dealing with the scope of the item to which a depreciation method change applies. Previously, an accounting method with regard to a change from capital to expense, or vice versa, was defined in terms of a *class* of assets. Although a class of assets was never defined in the regulations, it was understood to mean that the same type of an asset from one year to the next would be considered within the class, so that a taxpayer could not unilaterally change its treatment of an asset within that class from one year to the next without obtaining the Service's consent.

However, in 2003, a provision was added to Treas. Reg. § 1.446-1(e)(2)(ii)(d)(4), which provides in part as follows:

> *(4) Item being changed.*—For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(*d*) applies, the item being changed generally is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is determined under § 1.167(a)-11 (class life asset depreciation range (CLADR) property). Similarly, the item is the depreciable treatment of each general asset account with respect to a depreciable asset for which general asset account treatment has been elected under section 168(i)(4) or the item is the depreciation of each mass asset account with respect to a depreciable asset for which mass asset account treatment has been elected under former section 168(d)(2)(A).

The provision referred to in paragraph (e)(2)(ii)(d) of Treas. Reg. § 1.446-1 of the above-quoted regulation includes:

> [A] change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting.

Treas. Reg. § 1. 446-1(e)(2)(ii)(d)(2).

What the foregoing provisions mean is that under the 2003 version of the section 446 regulations, the scope of an accounting method and an accounting method change for items mischaracterized as deductible expenses or as capital expenditures is limited to the individual unit of property. Moreover, even in cases where a taxpayer uses a depreciation convention to group its property in a single account, the scope of the accounting method and accounting method change is limited to all units of property within the depreciation

grouping, which is normally limited to units of property placed in service in the same taxable year.

The foregoing limitation on the scope of a depreciation method change is perfectly logical because taxpayers normally have the right to elect different depreciation methods for units of property accounted for in item accounts and for units of property in group accounts that are placed in service in different taxable years. However, this type of scope limitation is not appropriate in the case of several of the methods of accounting contained in the temporary and proposed regulations dealing with capitalization-versus-expense issues.

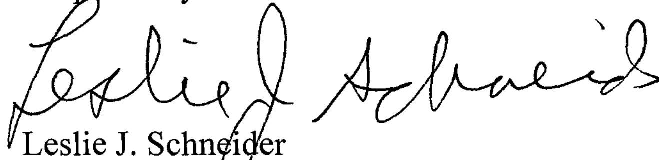
For example, it would not be appropriate for a taxpayer to be able to shift between the use and non-use or modified use of the *de minimis* method from year to year without filing a Form 3115. Likewise, it would not be appropriate for a taxpayer to be able to change the treatment of rotable spare parts from year to year without filing a Form 3115.

There are many methods of accounting like these in the temporary and proposed regulations where the scope of the method should be broader than each individual unit of property. However, if the provisions in Treas. Reg. § 1.446-1(e)(2)(ii)(d)(4) are not modified, the scope of every method and every method change in the temporary and proposed regulations will be narrowly limited to either each individual unit of property, or to all properties within a single depreciation grouping. Accordingly, the Treasury and

Service should give consideration to modifying the scope of an item in Reg. § 1.446-1(e)(2)(ii)(d)(4).

We appreciate the opportunity to comment on these proposed regulations and look forward to testifying at the public hearing.

Respectfully submitted



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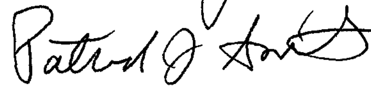

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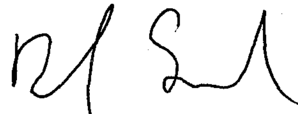

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