

To Capitalize or Not to Capitalize: That May Be a Difficult Question

By John H. Skarbnik and Ron West

John H. Skarbnik and Ron West examine when an expenditure should be currently deductible and when it should be capitalized and recovered over time.

I. Background

The purchase of property used in a trade or business is either currently deductible, as an ordinary and necessary business expense, or is capitalized and recovered through depreciation or amortization deductions over a stipulated statutory period.¹ Taxpayers wanting to accelerate deductions generally prefer to expense the deduction as an ordinary and necessary business expense. For example, a taxpayer who refurbishes equipment used in its business must determine whether the cost should be treated as maintenance, which is an ordinary and necessary current business expense, or as a capital expenditure that is deducted over the depreciation recovery period. The capitalization issue is one of timing. Should an expenditure be recovered currently or over a period of time?

Courts have long recognized the difficulties in determining whether a payment should be classified as capital. Early on, the U.S. Supreme Court stated, "One struggles in vain for any verbal formula that will supply a ready touchstone," as to what should be capitalized and what should be expensed.² Other courts have also expressed similar sentiments:

Some items are clearly capital and other items are clearly expense, but between the two extremes

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a point is approached at which it is difficult to determine whether the expenditure is capital or an expense.³

The line of demarcation between deductible repairs and additions to capital is, of course, obscure.⁴

The distinction between capital expenditures and ordinary and necessary business expenses evades easy description.⁵

Whether a business expense is capital is dependent on the particular circumstances of a given case and is ultimately a factual determination for the trial court.⁶

A taxpayer's accounting policy which determines whether an expenditure should be capitalized, affects the timing of deductions, and is therefore, a method of accounting.⁷ A taxpayer has the right to select a method of accounting as long as such method clearly reflects income.⁸ When a taxpayer's accounting method clearly reflects income, the IRS cannot compel the taxpayer to change its method of accounting.⁹

The issue of capitalization has remained murky. Following the government's victory in one capitalization case and its losses in two other cases in the early 2000s, the IRS and the Treasury recognized that they needed to provide better guidance on the issue of capitalization.¹⁰ Each of these three cases revolved around the issue of the proper unit of property that the respective taxpayers selected for the purpose of applying the various tests of whether

a payment should be capitalized or deducted as an ordinary and necessary business expense.

Shortly after its loss in the Federal District Court in *FedEx Corp.*,¹¹ the IRS announced in Notice 2004-6¹² that it intended to issue proposed regulations that would clarify the application of the capitalization rules: “The Service and the Treasury Department want to provide clear, consistent and administrative rules that will reduce the uncertainty and controversy in this area, while always preventing the distortion of income.”¹³ The notice, requesting comments on 15 specified issues, made it clear that the IRS was going to undertake a comprehensive review of the entire spectrum of issues affecting capitalization, including whether the current standards of capitalization should be changed:

The regulations currently require capitalization for expenditures that materially increase the value of property, substantially prolong the useful life of property, or adapt property to a new or different use. Sections 1.162-4; 1.263(a)-1(b) of the Income Tax Regulations. Are these the appropriate tests for capitalization? If so, how should the forthcoming guidance clarify the application of these standards? Alternatively, should different standards apply? If so, what different standards?

In August 2006, the IRS and the Treasury issued the first set of proposed capitalization regulations. (“First Set of Proposed Regulation”). In the preamble to the first set of proposed regulations, the Treasury and the IRS stated:

In recent years, much debate has focused on the extent to which section 263 (a) of the Code requires taxpayers to capitalize as an improvement amounts paid to restore property to its former condition; that is whether, or the extent to which the amounts paid to restore or improve the property are capital expenditures or deductible ordinary and necessary repair and maintenance expenses. There has been controversy, for example, regarding what tests to apply for determining capitalization or expensing, how to apply the tests, and the appropriate unit of property with respect to which to apply the tests.¹⁴

With regards to the unit of property, the preamble to the first set of proposed regulations stated:

A threshold issue in applying the improvement rules under §1.263(a)-3 of the proposed regulations is determining the appropriate unit of property to which the rules should be applied. For example, to determine whether an amount paid materially increases the value of property, it is necessary to know what property is at issue. The smaller the unit of property, the more likely it is that amounts paid in connection with that unit of property will materially increase the value of, or restore, the property. Taxpayers and the IRS frequently disagree on the unit of property to which the capitalization rules should be applied.¹⁵

In March of 2008, the first set of proposed regulations were withdrawn and at the same time the Treasury and the IRS released the second set of proposed regulations (“second set of proposed regulations”).¹⁶ The second set of proposed regulations make numerous proposed changes to the existing capitalization rules set forth in the current final regulations and also provide a number of safe harbors for taxpayers. Except as may otherwise be stated, all references to the proposed regulations within this article are to the Second Set of the Proposed Regulations. Although the proposed regulations provide some clarity to taxpayers, there are still issues that remain unresolved.

This article is organized in several sections. Section II, “Method of Accounting and Capitalization Policy,” analyzes capitalization as an accounting method. Section III, “Capitalization vs. Repair—Overview,” elaborates on the general capitalization rules as provided under the Internal Revenue Code, the existing final regulations, and some selected judicial decisions. Section IV examines several specific capitalization topics including, the unit of property, the functional interdependence test, the *de minimis* expenditures exception, and the plan of rehabilitation doctrine. Section V reviews the Proposed Regulations, and Section VI offers some final thoughts.

II. Method of Accounting and Capitalization Policy

A taxpayer is directed to compute its taxable income under the same basis that the taxpayer “regularly computes his income in keeping his books.”¹⁷ A taxpayer is required to maintain records to file a cor-

rect return. Accounting records include the regular books of account “and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and return.”¹⁸ Income can be reported differently for tax and financial accounting reporting provided that the taxpayer maintains adequate reconciliation documents.¹⁹

A taxpayer has discretion in selecting a method of accounting, provided that the method selected reflects the taxpayer’s income and is consistently followed:²⁰

It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable, unless in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expenses are treated consistently from year to year.²¹

A taxpayer may select any permissible method of accounting in computing taxable income upon filing a tax return that first adopts the accounting method. To change an accounting method, a taxpayer generally must secure the consent of the IRS before making the change of the accounting method.²² However if a taxpayer without permission changes its method to a permissible method and has consistently applies the changed accounting method, the IRS cannot force the taxpayer to change the method if the statute of limitation has expired for the year the change was first made.²³

Once an election has been made selecting a permissible method of accounting, the taxpayer generally cannot change it without receiving the

consent of the IRS. In *E. Marandola, Jr.*, the U.S. Court of Federal Claims held that a taxpayer may not change its method of accounting by filing amended tax returns: “When a taxpayer submits an amended return after the date prescribed for filing the original return, the IRS generally is not required to accept the changes proffered by the taxpayer on that amend-

ed return insofar as the changes are attributable to a different accounting method than that used on the original return.”²⁴

A change in method of accounting encompasses a change in the overall method of accounting, as well as, a change in the treatment of any material item:²⁵ “A material item is any item that involves the proper time for the inclusion of the item in income or the taking of

the item as a deduction. In determining whether a taxpayer’s accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer’s lifetime income. If the practice does not permanently affect the taxpayer’s lifetime income, but does or could change the tax year in which income is reported, it involves timing and is therefore a method of accounting.”²⁶

A taxpayer’s capitalization policy affects the timing when an amount paid for property is deducted and is, therefore, a method of accounting. The regulation provide that a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or *vice versa*, is a change in a method of accounting requiring permission of the IRS before a change may be made.²⁷

The accounting method selected must clearly reflect the taxpayer’s income. If not, “the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”²⁸ The term “clearly reflect income” is not defined in the Internal Revenue Code. In most cases, an accounting method that is in accordance with “generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations” will be acceptable.²⁹ The consistency requirement

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is met when a taxpayer treats a material item in a similar manner in two or more consecutively filed tax returns.³⁰ Even though the accounting method has not been applied consistently for two or more consecutive years, if the taxpayer treats an item properly in his first return, he will be deemed to have adopted a method of accounting.³¹

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When the IRS determines that the taxpayer's accounting method does not clearly reflect income, the taxpayer has a heavy burden to show that the IRS abused its discretion.³³ As the Seventh Circuit in *JP Morgan Chase & Co.* stated:

Deference to the Commissioner is appropriate because, as the Supreme Court has counseled, "[i]t is not the province of the court to weigh and determine the relative merits of systems of accounting." *Brown v. Helvering*, 291 U.S. 193, 204–05 [13 AFTR 851] (1934) (citing *Lucas v. Am. Code Co.*, 280 U.S. 445, 449 [8 AFTR 10278] (1930)). As another circuit has stated, in situations in which a "taxpayer's method does not reflect his income... the Revenue Act contemplates action by the Commissioner, not by the courts." *Harden v. Comm'r*, 223 F.2d 418, 421 [47 AFTR 1284] (10th Cir. 1955).³⁴

However, when the taxpayer's income is clearly reflected, the IRS cannot force the taxpayer to change its method of accounting: "Notwithstanding the authority conferred under section 446(b), the Commissioner cannot require a taxpayer to change to another method where the taxpayer's method of accounting does clearly reflect income, even if the method proposed by the Commissioner more clearly reflects income."³⁵ A reviewing court will determine whether the IRS abused its discretion.³⁶

In *Cincinnati, New Orleans and Texas Pacific Railway*,³⁷ the taxpayer adopted a policy that expenditures which did not exceed \$500 should be expensed rather than capitalized. The IRS argued that the taxpayer's policy was contrary to Internal Revenue Code,³⁸ which requires capitalization of "permanent improvements or betterments made to

increase the value of any property... ." In further support, it referenced its regulation³⁹ that requires a taxpayer to capitalize expenditures having a substantial life extending beyond the tax year. Upholding the capitalization method of the taxpayer, the U.S. Court of Federal Claims stated that if it accepted the IRS's position, it would be making the Internal Revenue Code section which permits a taxpayer to select a method of accounting that clearly reflects its income subordinate to the capitalization statute.

III. Capitalization vs. Repair— Overview

The Internal Revenue Code provides, "No deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."⁴⁰ The current Treasury Regulations provide that no deduction shall be allowed for the following:

- (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate
- (2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a depreciation, amortization or depletion⁴¹

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." Capital expenditures also include amounts paid or incurred to (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.⁴² In contrast, a current deduction is allowed for repairs. The current regulations provide:

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.⁴³

The Third Circuit, in *R.K. Walling Est.*,⁴⁴ distinguished between repair and capital expenditures by stating, “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.” With regards to a restoration, in *J.S. Moss*, the Ninth Circuit Court of Appeals stated, “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.”⁴⁵ In certain circumstances, where an improvement that would normally be considered a deductible repair is made as part of a general plan of rehabilitation, the cost of the improvement must be capitalized.⁴⁶

In *Cinergy Corp.*,⁴⁷ the government argued that the taxpayer should capitalize the amount paid to remove and encapsulate asbestos from a building that was operational both before and after the expenditure. The court held that it was proper to deduct the expense as a repair since it kept the asset in efficient operating condition. Quoting the Tax Court in *Plainfield Union Water Co.*,⁴⁸ the *Cinergy* court stated, “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.”⁴⁹ The *Cinergy* court also relied upon the *Walling Est.*⁵⁰ “put and keep” approach, which requires that an expense be capitalized where the improvement “puts” a property into operating condition, whereas the expense is deductible if it “keeps” a property in operating condition. Applying those standards, the *Cinergy* court determined that the removal of the asbestos was a deductible expense since the expenditure allowed the taxpayer to continue using the building.

The *Cinergy* court distinguished its case from the Fourth Circuit case of *Dominion Resources, Inc.*⁵¹ In

Dominion Resources the court held that the cost of removal of asbestos-containing materials, sludge and assorted contaminants from a power plant should be capitalized since the expenses were incurred as part of the conversion of a power plant to an entirely new use as a real estate development.

The regulations on repairs, as quoted above, state that “[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”⁵² Courts have

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wrestled with the issue of whether the word “incidental” creates a secondary test that must be met before a repair can be expensed. In *FedEx Corp.*, the court rejected

the government’s argument that “the adjective ‘incidental’ creates an independent test of magnitude under which a court could find that an item must be capitalized.”⁵³ The government argued that the use of the word “incidental” in the regulations indicates that “incidental” repairs are only those whose cost is small relative to the value of the item repaired. The court indicated that such an argument is not supported by the case law. Instead, the court determined that “[i]ncidental’ is not logically read ... 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.”⁵⁴ The test of whether a repair is deductible, therefore, remains whether the expense materially adds value to or prolongs the life of the asset.

Explaining the term “incidental repairs” in *S.B. Scallen*,⁵⁵ the Tax Court stated, “Incidental repairs that keep property in ordinary and efficient operating condition and that do not add value to the property are ordinarily deductible expenses.” Similarly, in *Moss*,⁵⁶ the Tax Court stated, “Generally, repairs are incidental expenses that keep property in its ordinarily efficient operating condition but neither materially add to its value nor appreciably prolong its life.”⁵⁷ Repair expenditures are deductible if they are incidental to maintaining property in its ordinarily efficient operating condition, but must be capitalized if they are incidental to capital expenditures for remodeling or renovation in a newly acquired

asset.⁵⁸ In *Bank of Houston*,⁵⁹ the Tax Court stated, “When the work is incidental to keeping the property in ordinarily efficient operating condition, it is a repair, and the cost is deductible as an expense. However, when the item is incidental to a general plan of rehabilitation, improvement, alteration, and modernization, the cost must be capitalized.”

In determining whether an expense increases the value of property, an important issue is the appropriate time for making the comparison. The *FedEx* court, adopting the test articulated in *Plainfield-Union Water Co.*,⁶⁰ stated, “[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.” The *FedEx* court also stated it had to look at the state of the engines and the auxiliary power units before the condition necessitating the expenses. Since the condition arose from the normal wear and tear, the court reasoned that it was necessary to compare the condition of the aircraft after its previous maintenance. The court found there was no increase in the value of the aircraft and, as such, the maintenance expense was properly expensed.

IV. Various Capitalization Issues

A. The Unit of Property Being Repaired or Improved

To determine whether an amount paid should be capitalized or expensed, it is critical to identify the proper unit of property. Pursuant to current regulations, a taxpayer must determine whether expenditures paid or incurred either (1) add to the value, or substantially prolong the useful life of the unit of property; or (2) adapts the property to a new or different use.⁶¹

To be currently deductible, the replacement or a repair of a component cannot extend the useful life or the value of the unit of property. Rather than view the component in isolation, the focus of inquiry is whether the expenditure increases the value, use or useful life of the larger unit, not the component. This is illustrated in *FedEx Corp.*⁶²

In 1993 and 1994, Federal Express, Inc. (“FedEx”) deducted certain expenditures that it incurred for off-aircraft inspection, heavy maintenance and repair of jet aircraft engines and auxiliary power units (APUs). Engine visits were sometimes planned based

upon engine use and at times were also scheduled to comply with the Federal Aviation Administration requirements. The average interval between visits was 24–36 months for one type of engine and 48–60 months for another type of engine. If an engine was used for a certain designated number of hours it was deemed no longer “airworthy” and could not be used until necessary inspections were made and repairs were made. The inspection required the removal and replacement of the engine. Typically, only one of a plane’s three engines would be serviced at one time. The engine and APU would be disassembled and inspected and, if necessary, parts were replaced or serviced. Virtually all jet aircraft engines and APUs were either acquired or leased by FedEx as installed components or as spare parts of aircrafts that it acquired. The District Court noted that there were purchases of stand-alone engines and APUs but they were not significant. The District Court also noted that the economic useful life of the airframes and aircraft operated by FedEx constituted the useful life of the aircraft.

The court recognized that when an item is a component of a larger part 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.”

Relying upon two earlier court decisions, *Ingram Industries, Inc.*,⁶³ and *J.L. Smith*,⁶⁴ the *FedEx* court articulated four factors that should be considered in identifying the appropriate unit of property: (1) whether the taxpayer and the industry treat the component as part of the larger unit of property; (2) whether the economic useful lives of the component and the larger unit are coextensive; (3) whether the two units can function without each other; and (4) whether the component is maintained while attached to the larger unit. The court stated that not all factors have to be met, nor is any one factor determinative.

The *FedEx* court then applied the four-part test to the facts in the case as follows, finding that the engines and the APUs were components of the airplane, the unit of property:

■ **Factor 1.** The court found that the taxpayer and the industry treat the engines and APUs as components of the airplane rather than as separate units of property. The court stated that based

upon evidence produced at trial, major air carriers considered engines and APUs to be part of an aircraft.

- **Factor 2.** Finding the economic useful life of the engines and the aircraft were co-extensive, the court stated, “If an engine is not regularly or 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 Court stated that FedEx expected all of their main components to last 30 years.

Factor 3. The court found a co-dependency between the aircraft and the engines and the APUs: Aircraft could not operate without the engine and APU, and the engine could not function without the aircraft. The court noted that this test is similar to the “functional interdependence test” set forth in the regulations.⁶⁵

- **Factor 4.** The court held that the fourth factor, whether the component is repaired while attached to the larger unit was not met, since the engines were not repaired while being attached to the aircraft. Although the engines were removed for servicing, the court stated, “[T]his 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.”

On appeal, *FedEx Corp.*,⁶⁶ the Sixth Circuit, in a one-page opinion, affirmed the decision of the District Court, stating, “We cannot improve upon the District Court’s opinion, which carefully and correctly sets out the law governing the issues raised, and clearly articulates the reasons underlying its decision. Issuance of a full written opinion by this court would therefore serve no useful purpose.”

In *Ingram Industries, Inc.*,⁶⁷ a case decided prior to the *FedEx* case that was discussed in its decision, the Tax Court held that a tugboat’s engines were a component of the tugboat, which was the unit of property. The taxpayers in *Ingram* were a group of closely held corporations engaged in a variety of business activities, including barge transportation services conducted by three wholly owned subsidiaries. The question before

the court was whether certain expenditures made to a tugboat’s engine, costing approximately \$100,000, must be capitalized. The taxpayer deducted the amount paid as maintenance expenses on its tax returns but capitalized the expenses and expensed the payment for financial purposes based upon the hours of use. The taxpayer contended that the engine had a useful life equal to that of a tugboat, and the expenditures were to maintain the tugboat. The Tax Court

agreed with the taxpayer, stating it was “significant that the petitioners perform the procedures at a time when the engines are completely serviceable and the purpose of

performing the procedures is to keep the tugboat engines in good operating condition.” The Tax Court reasoned that, in the towboat industry, engines are not separately appraised and have very little effect on the value of the towboat, which is to be treated as the unit of property. In addition, the Tax Court found that the useful life of the towboat and its engines were coextensive, so long as the engines were properly maintained. For those reasons, the Tax Court held that the expenditures were deductible as repair expenses to the towboats.

However, in *Smith*,⁶⁸ also a pre-*Fed Ex* case, the court upheld the government’s position that the appropriate unit of property was an individual cell, not the line of cells. The taxpayer maintained an aluminum smelting operation through the use of a line of 650 aluminum-producing cells. The taxpayer sought to deduct the expenses associated with relining the individual cells. Eight to 10 cells would be removed at a time for relining, but the system could operate with as few as 112 functioning cells. The Ninth Circuit Court of Appeal held that the individual cells were the appropriate unit of property; therefore, the expenses related to relining must be capitalized. The court relied upon the facts that an individual cell was capable of producing aluminum, even though the taxpayer’s operation was not set up to operate in that manner, and that the line could operate with most of the cells removed.

The District Court in *FedEx* distinguished *Smith*: “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 court in *Smith* stated that the cell lining had no functional life remaining at the time

The proposed regulations, if they become final, will not eliminate all capitalization issues.

the cell was relined. The replacement of the cell lining was an “essential component” of the cell and therefore it was proper to capitalize same. In the *FedEx* case, the District Court found that the engines were not functionally exhausted at the time they were removed for servicing. The court also found that the engines were not essential components based upon the *Smith* decision because their replacement would not be “tantamount to reconstituting the [airplane] itself.”

B. The Unit of Property Rules and Functional Interdependence

The third *FedEx* test, whether a component could function independently from a larger unit, is similar to the functional interdependence test appearing in the regulations. As the court stated in *FedEx*, the functional interdependent test, developed in a different context,⁶⁹ provides that components of property should be treated as a single unit if they are functionally interdependent:⁷⁰

Components of tangible personal property are a single unit of property if the components are functionally interdependent. Components of tangible personal property that are produced by, or for, the taxpayer, for use by the taxpayer or a related person, 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. In the case of tangible personal property produced for sale, components of tangible personal property are functionally interdependent if they are customarily sold as a single unit. For example, if an aircraft manufacturer customarily sells completely assembled aircraft, the unit of property includes all components of a completely assembled aircraft. If the manufacturer also customarily sells aircraft engines separately, any engines that are reasonably expected to be sold separately are treated as single units of property.⁷¹

The *FedEx* court noted that the courts in *Ingram*⁷² and *Smith*⁷³ both found that functional interdependence was an important consideration in determining the correct unit of property. In *Ingram*, the Tax Court determined that a towboat and its engine are purchased and treated as a single unit of property. It was designed to allow the engine to

be maintained without removing it from the boat. In *Smith*, the court found that in producing aluminum, “[e]ach cell ... was essentially interchangeable, capable of being withdrawn from the cell lines for repair purposes and replaced by a different cell.” Thus, the court held that the individual cell, as opposed to the entire line, was the appropriate unit of property for determining the deductibility of repair expenses. Along these lines, the *FedEx* case, in discussing *Smith*, observed:

There is an important difference between the cells in *Smith* and the engines and APUs in the case at bar: in *Smith*, large number of cells could be removed without interfering with the functioning of the cell line. *FedEx* airplanes, in contrast require an APU and three engines working at all times. In addition, the cells in *Smith* could individually produce aluminum-aircraft engines and APUs cannot—aircraft engines and APUs separate from the aircraft cannot accomplish their purposes.

Notwithstanding, the *FedEx* court stated in footnote 10 that it declines to adopt the functional interdependence test as an absolute test for determining a unit of property, though it is “an important factor in determining which unit of property to use in applying the Repair Regulations.”

In its proposed regulations, discussed in greater detail below, the IRS and the Treasury agreed with the *FedEx* decision that functional interdependency is a factor to be taken into account but is not determinative of the unit. The Preamble to the first set of proposed regulations states that the functional interdependence test may not always produce a correct result.

Further, in determining the appropriate unit of property for purposes of Code Sec. 263(a), the functional interdependence test does not always produce appropriate results. For example, a taxpayer might argue that application of that test results in an entire complex of structures and machinery, such as an entire power plant, being treated as a single unit of property. The IRS and the Treasury do not believe that result is correct for purposes of Code Sec. 263(a).

Subject to a number of exceptions discussed in Section V of this article,⁷⁴ the second set of the proposed regulations adopt the “functional interdependence test” for tangible personal property.⁷⁵

C. Exception for *De Minimis* Expenditures

Must a taxpayer who purchases property that has a useful life that extends substantially beyond the close of the tax year capitalize such cost when such amount does not exceed a *de minimis* amount? This issue has been confronted by several courts.

In *Cincinnati, New Orleans and Texas Pacific Railway*,⁷⁶ the Court of Federal Claims allowed the taxpayer to deduct *de minimis* expenditures, finding that the clear reflection of income was not distorted. The taxpayer operated a railroad as a common carrier and was subject to supervision of the Interstate Commerce Commission (ICC). The ICC required that the financial statements of rail carriers be prepared in compliance with its "General Instructions of Accounting Classifications." The ICC had an established rule that expenditures that did not exceed \$500 should be expensed rather than capitalized. The IRS audited the taxpayer's 1947, 1948 and 1949 returns, on which all items costing less than \$500 were expenses. Upon audit, the IRS disallowed the deductions taken for all expenditures exceeding \$100.⁷⁷ The IRS asserted in court that the Internal Revenue Code⁷⁸ requires capitalization of "permanent improvements or betterments made to increase the value of any property ..." In further support, it referenced its regulation,⁷⁹ which requires a taxpayer to capitalize expenditures having a substantial life extending beyond the tax year. The U.S. Court of Federal Claims rejected the IRS position stating that if it accepted the IRS's position, it would be making the Internal Revenue Code provision,⁸⁰ which permits a taxpayer to select a method of accounting that clearly reflects its income, subordinate to the capitalization statute.

The U.S. Court of Federal Claims relied upon existing regulations, which recognized, "No uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to its purpose."⁸¹

The Claims Court reasoned that in determining whether the taxpayer's method of accounting clearly reflects income, "the one year rule will be given adequate, though not conclusive, weight."⁸² Thus, even though an expenditure may have a useful life that extends substantially beyond the tax year, it may not have to be capitalized. The court noted that although the accounting procedures of the ICC are not binding

upon the IRS, the ICC findings that the imposition of the \$500 minimum would not distort income is entitled to probative weight. It then reviewed data that the taxpayer submitted to the court and concluded that the adoption of the *de minimis* rule did not distort its income. The salient data in support of the outcome follow:

- Over a 17-year period, the aggregate disallowed expenses by the IRS represented less than 0.06 percent of the taxpayer's operating expenses.
- For the 17-year period, the aggregate *de minimis* expenses represented less than one percent of the taxpayer's total depreciation deduction.
- Over the 17-year period, the aggregate *de minimis* expenses remained relatively constant.
- If the taxpayer reported its income in accordance with the method of accounting insisted upon by the IRS and depreciated the assets over a 15-year period, the taxpayer's income in each of the years would have increased by less than one percent.

The same issue arose in *Union Pacific Railroad Co.*,⁸³ where the Claims Court summarily stated that there is no reason not to follow its earlier decision in *Cincinnati, New Orleans and Texas Pacific Railway, supra*.

In 1972, following the Claims Court's decision in *Cincinnati, New Orleans and Texas Pacific Railway*, the IRS General Counsel published GCM 34959, which recommended that the IRS not appeal the decision. It also proposed the adoption of a \$100 *de minimis* rule. The General Council Memorandum further stated, "In addition, if a taxpayer's accounting method allows expending of more costly items, even though they have a useful life in excess of one year, and such method is generally accepted by the accounting profession for that industry and produces no distortion of income, use of such method should be permitted."

Use of the *de minimis* rule was held unacceptable in *Alacare Health Services, Inc.*⁸⁴ In that case, the Tax Court held that a certified home health care agency's accounting method, which followed Medicare guidelines and expensed office equipment and other assets that cost less than \$500 and had a useful life of over one year, did not show that its accounting method clearly reflected income in 1995 and 1996. The result was reached by applying a number of the factors listed in *Cincinnati, New Orleans and Union Pacific Railway, supra*. In *Cincinnati*, the disputed items were less than

one percent of the taxpayer's taxable income and were less than two percent of the total depreciation deduction for the years which were in dispute. In *Alacare*, the disputed items were 165 percent and 83.5 percent of the taxpayer's taxable income in the two audit years, and the disputed items were 288 percent and 189 percent of its total depreciation deductions for the years respectively.

In a field service advice published in 1992, the IRS held that a taxpayer had to meet a two-part test before the taxpayer could adopt a *de minimis* test. First, the use of an accounting method that permits a taxpayer to deduct an amount that does not exceed a designated amount cannot result in a distortion of income. Second, its use must be an acceptable method of accounting. The IRS stated, "We believe that use of the rule in a non-regulated industry with no clear accounting rule or industry-wide practice does not amount to a permissible method of accounting that must be recognized for federal tax accounting purposes."⁸⁵ Based upon the foregoing, in a nonregulated industry, this second test may be difficult to meet.

In a 1999 chief counsel advice,⁸⁶ the IRS denied a taxpayer's request to change its accounting policy to increase from \$1,000 to \$2,000 the *de minimis* amount that it utilizes to determine whether it would capitalize purchases. It stated:

The taxpayer's current method of not capitalizing assets valued at a certain amount or less is not an acceptable method of accounting. All property used in a trade or business (except land or inventory) that has a useful life of more than one year must be capitalized and depreciated. Taxpayers are not permitted to treat such items as current expenses simply because the particular item has a certain minimum value or less.

D. The Plan of Rehabilitation Doctrine

Expenditures that, standing alone, would pass muster as deductible repairs must be capitalized when they are made as part of a "general plan" of rehabilitation.⁸⁷ Recent court decisions, as well as IRS rulings, have reaffirmed this concept, known as the plan of rehabilitation doctrine.

In *W.J. Wehrli*,⁸⁸ the Tenth Circuit articulated the modern rendering of the doctrine: "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."⁸⁹ The court also determined that the questions of whether a general plan exists and whether a particular expense is a part of the plan are fact-specific inquiries that must be determined on a case-by-case basis. The court described several factors that should be considered, including:

... 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, in any event, whether what was done resulted in an appreciable enhancement of the property's value.⁹⁰

Relying on the factors set forth above, several recent cases have applied the plan of rehabilitation doctrine in determining the nature of repair expenditures.

The doctrine was held inapplicable in *Moss*,⁹¹ where the taxpayer incurred almost \$2 million in repairs to upgrade a hotel. The improvements included expenses, which the taxpayer capitalized, to replace carpeting, drapes, beds and other furniture in the hotel rooms. In addition, the taxpayer made expenditures to repaint and repaper the hotel, which the taxpayer expensed. The court recognized that the capital expenditures were the costs of replacing particular assets (beds, furniture, carpeting, etc.). On the other hand, the repair expenses pertained to an entirely separate asset, the hotel structure itself. The court stated, "[t]o 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."⁹² The court then found that the fact that the hotel was generally suitable for its intended use while the repairs were being made weighed against applying the plan of rehabilitation doctrine. The court concluded that the improvements were "consistent with the type of annual maintenance activities necessary to maintain the hotel in first-class condition"⁹³ and, as such, the plan of rehabilitation doctrine did not apply.

In *Norwest Corp.*,⁹⁴ the Tax Court applied the plan of rehabilitation doctrine in a case involving asbestos removal in preparation for remodeling the taxpayer's office building. The taxpayer decided to remove the asbestos in the building prior to un-

dertaking renovations because of the probability that the renovations would disturb the asbestos and increase the amount of asbestos fibers in the air. The Tax Court found that the main purpose of the asbestos removal was to allow the remodeling of the building to take place while minimizing health risks. The Tax Court stated, "The asbestos removal and remodeling were part of one intertwined project, entailing a full-blown general plan of rehabilitation, linked by logistical and economic concerns."⁹⁵ The court held that the costs of the asbestos removal must be capitalized along with the costs of the renovations because they were all part of the general plan of rehabilitation that improved the building. In contrast, in *Cinergy Corp.*,⁹⁶ the Court of Federal Claims held that the rehabilitation doctrine did not apply where the removal of asbestos was not part of a broader plan of renovations.

The Tax Court also had occasion to address this issue in *H.S. Schroeder*.⁹⁷ The taxpayer in *Schroeder* incurred repair expenditures for work performed on the taxpayer's farm. Most of the expenses were related to minor repairs made to barns, such as painting and patching roofs. The Tax Court found that the capital expenditures incurred by the taxpayer were not substantial and did not make up a large portion of the total expenditures. The court determined that the plan of rehabilitation doctrine did not apply because the buildings were suitable for use prior to and during the repairs, and because the structures of the buildings were not altered.⁹⁸

In Rev. Rul. 2001-4,⁹⁹ the IRS set forth certain principles it uses in determining whether the plan of rehabilitation doctrine should apply to a particular situation. The IRS explained that expenses incurred to keep an asset in an ordinarily efficient operating condition do not trigger the plan of rehabilitation doctrine. Additionally, the fact that capital improvements are incurred at the same time as other routine repairs does not require capitalization of all of the expenditures; the repairs must be an actual part of a general plan of rehabilitation, modernization or improvement to the asset as determined based on all the facts and circumstances.

V. Proposed Regulations

In August 2006, the IRS and the Treasury issued the first set of proposed capitalization regulations. In its preamble to the proposed regulations, the Treasury and the IRS stated:

In recent years, much debate has focused on the extent to which section 263 (a) of the Code requires taxpayers to capitalize as an improvement amounts paid to restore property to its former condition; that is whether, or the extent to which the amounts paid to restore or improve the property are capital expenditures or deductible ordinary and necessary repair and maintenance expenses. There has been controversy, for example, regarding what tests to apply for determining capitalization or expensing, how to apply the tests, and the appropriate unit of property with respect to which to apply the tests.¹⁰⁰

In March of 2008, the first set of proposed regulations were withdrawn at the same time the Treasury and the IRS released the second set of proposed regulations.¹⁰¹ In the Preamble to the second set of proposed regulations, the government stated that it included many of the provisions contained in the first set of proposed regulations. The second set of proposed regulations included a number of provisions that were not included in the first set including a book conformity *de minimis* test for acquisitions of units of property, a safe harbor for routine maintenance and an optional simplified method for regulated taxpayers. Furthermore, the second set of proposed regulations also makes significant changes to unit of property rules, restorations and permits for industry-specific repair allowance methods under guidance that will be published by the IRS in the future.

The second set of the proposed regulations will not become effective until the first tax year beginning on or after the final regulations are published in the Federal Register. The final regulations will provide rules applicable to taxpayers seeking to change a method of accounting to comply with the final regulations. The preamble states that taxpayers may not change a method of accounting in reliance upon the rules contained in these new proposed regulations until the rules are published in the Federal Register.¹⁰²

The discussion that follows will cover the second set of the proposed regulations and will contrast it with the current regulations.

A. General Capitalization Standards

Currently, Reg. §1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred to (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. The proposed regulation restates the capitalization rule as follows:

[T]axpayer must capitalize the aggregate of related amounts paid to improve a unit of property, whether the improvements are made by the taxpayer or by a third party, and whether the taxpayer is an owner or lessee of the property... A unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer (i) *result in a betterment to the unit of property* (see section (f) of this section); or (ii) Restore the unit of property (see paragraph (g) of this section) or (iii) adapt the unit of property to a new or different use (see paragraph (h) of this section).¹⁰³

The preamble to the second set of proposed regulations states that the material increase in value standard has been “renamed the ‘betterment’ standard because the betterment standard more closely reflects the manner in which Code Sec. 263 (a) has been interpreted and applied under current law.”¹⁰⁴ The preamble further states that the cost of a betterment should be capitalized “regardless of whether the betterment increases the fair market value.”¹⁰⁵

To determine whether an amount paid results in a betterment, the proposed regulations provide generally, an amount results in a betterment of a unit of property only if it:

- (i) Ameliorates a material condition or defect that existed prior to the taxpayer’s acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of condition or defect at the time of the acquisition or the production¹⁰⁶;
- (ii) Results in a material addition (including a physical enlargement, expansion, or extension) to the unit of property; or
- (iii) Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the unit of property, or the output of the unit of property.¹⁰⁷

In testing whether betterment occurs, all facts and circumstances should be considered.¹⁰⁸ The proposed regulations further provide that a comparison must be made between “the condition of the property immediately after the expenditure with

the condition of the property immediately prior to the circumstances necessitating the expenditure.”¹⁰⁹ The proposed regulation provides that where “an expenditure is made to correct normal wear and tear to the unit (including amelioration of a condition or defect that existed prior to the taxpayer’s acquisition of the unit of property) the condition of the property prior to the circumstances necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear, or if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer.”¹¹⁰ For example, amounts paid by the owner of a store to replace all the wooden shingles on the roof with new wooden shingles following a storm do not have to be capitalized. The proposed regulations state that the event necessitating the expenditure was the storm. Prior to the storm, the store was operating for its intended purpose. The expenditure did not result in an increase in capacity, productivity, efficiency, strength or quality of the shop compared to the condition of the shop prior to the storm.¹¹¹

The proposed regulations include an explicit provision that “[t]axpayers must capitalize amounts paid to adapt a unit of property to a new or different use.”¹¹² Moreover, taxpayers must capitalize such expenditures even if they do not qualify as betterments. The proposed regulations also recognize that consistent with the uniform capitalization rules of Code Sec. 263A, taxpayers must capitalize materials and depreciation deductions attributable to equipment used in producing or acquiring property for resale.¹¹³

B. Unit of Property

The test of whether an item must be capitalized as a result of a betterment is based upon the appropriate unit of property. The proposed regulations contain separate tests for real property and for tangible property other than realty.

A building and its structural components are a single unit of property.¹¹⁴ The proposed regulations define building and its structural components by cross referencing to the definitions set forth within the existing general business tax credit regulations.¹¹⁵ Building is defined as “any structure or edifice enclosing a space within its walls and usually covered by a roof.”¹¹⁶ Structural components “includes such parts of a building as walls, partitions, floors, and ceiling, as well as permanent coverings therefore

such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air condition or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.”¹¹⁷ Tangible property contained within a building will be a separate unit of property.¹¹⁸

The test for tangible personal property is based upon “functional interdependence.”¹¹⁹ “Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.”¹²⁰

Notwithstanding the foregoing, a taxpayer must treat property as a separate unit of property if at time the property is placed in service, the taxpayer recorded on its books and records used for financial or regulatory accounting, an economic useful life for the component different than the economic useful life of the unit of property of which the component is a part.¹²¹

Property that is classified as plant property must be treated as a separate unit of property when each component performs a distinct function. Plant property is defined as property used in “an industrial process such as manufacturing, generation, warehousing, distribution, automated material handling in service industries.”¹²² The proposed regulations provide an example of a taxpayer engaged in a uniform and linen rental business that operates a plant to launder uniforms and linens. The taxpayer has two separate production lines, one for uniforms and the other linens. Each line includes sorters, boilers, washers, dryers, ironers, folders and waste water treatment system. Since each laundry line is functionally interdependent, it is initially treated as a separate unit of property. Each unit is then further divided into smaller units because the sorters, boilers, washer, dryer, ironer, folder and waste water treatment system in each line performs a discrete and major function within the line.¹²³

In another example, a taxpayer operates a retail restaurant that prepares and serves food to retail customers. Within its restaurant, X has a large piece of equipment that uses an assembly line process to prepare and cook tortillas. The assembly line to pre-

pare and cook tortillas is the unit of property. It is not further divided in smaller units because the tortilla line is not plant property since it is not being used in an industrial process, but rather on a small scale in a retail operation.¹²⁴

C. Materials and Supplies

The proposed regulations contain detailed rules concerning materials and supplies. They also contain a new definition of rotatable parts and spare parts. These new rules will replace the current regulation, which is only two sentences long.¹²⁵

The proposed regulations adopt the general standard under case law that materials and supplies are generally deductible in the tax year in which the materials and supplies are used or consumed in the taxpayer’s operations.¹²⁶ If the materials and supplies have a useful life in excess of one year, the cost may have to be capitalized.¹²⁷

Materials and supplies are defined as tangible property that is used or consumed in the taxpayer’s operation and that are (i) not a unit of property; (ii) a unit of property that has an economic useful life of 12 months or less¹²⁸; (iii) a unit of property that has an acquisition cost or production cost of \$100 or less¹²⁹; or (iv) identified in published guidance in the Federal Register or the Internal Revenue Bulletin as a material or supply.¹³⁰

The proposed regulations create a new category of assets, which are treated as materials and supplies: rotatable and temporary spare parts. However, unlike the general rule that applies to materials and supplies, rotatable spare parts and temporary spare parts are generally deductible the year it is disposed.¹³¹ The proposed regulations provide that “rotatable spare parts are parts that are removable from the unit of property, generally repaired or improved, and either reinstalled on other property, or stored for later installation. Temporary spare parts are parts that are used temporarily until a new or repaired part can be installed, and then removed and stored for later (emergency or temporary) installation.”¹³²

Taxpayers may elect to treat as a capital expenditure the cost of any material or supply, unless the material or supply is a component of a unit of property. This rule should have particular attraction for taxpayers who purchase rotatable spare parts and temporary spare parts. Rather than deduct a rotatable spare part in the year in which it is disposed, a taxpayer may make an election to capitalize the expenditures in the year the property is placed in service and begin

depreciating the part.¹³³ If an asset is classified as rotatable part, by capitalizing the cost, a taxpayer will accelerate the time when the taxpayer recovers the cost of the part through depreciation, since, if no election is made, the taxpayer will claim an expense for the cost in the year of disposition. For example, a commercial aircraft carrier may retain a stock of engines that it uses to replace or temporarily install on its planes when it services its engines. Expenditures for engines purchased to be used as either a rotatable part or a temporary spare part will not be deductible until the year it is disposed, unless the taxpayer elects to capitalize the cost.

Spare parts that are not a unit of property or rotatable spare parts and that do not better the unit of property may be deducted as materials in the year they are utilized or consumed. A taxpayer operates a fleet of aircraft and uses spare parts that are not separate units of property to repair the aircraft. The taxpayer can deduct the expenditures relating to the spare parts in the year the spare parts are used to repair and maintain the aircraft.¹³⁴ An owner of an apartment building that pays for the acquisition, delivery and installation of a new window to replace the broken window may deduct the cost of the replacement window the year in which it is installed.¹³⁵

D. Restoration of Property

The preamble to the proposed regulations states that the “regulations provide a series of bright-line rules to determine when an amount paid is deemed to restore property. Although some commentators criticized the rules that deem the cost of certain activities to be capitalized as restoration, the IRS and Treasury Department think that bright lines will reduce controversy and help ease administration.”¹³⁶ A taxpayer must capitalize expenditures which restore a unit of property when such expenditure:

- (i) Is for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component;
- (ii) Is for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- (iii) Is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis

- adjustment as a result of a casualty loss under Code Sec. 165 or relating to a casualty event;
- (iv) Returns the property to ordinary efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;
- (v) Results in the rebuilding of the unit of property to a like-new condition after the end of its useful life;¹³⁷ or
- (vi) Is for the replacement of a major component or a substantial structural part of the unit of property.¹³⁸

The proposed regulations provide a number of examples. In Example 1, based upon a cost segregation study of a manufacturing building, a taxpayer determined that a walk-in-freezer is tangible personalty (not part of the real estate) and treated it as a separate unit of property. The components of the walk-in-freezer ceased to function and the taxpayer replaces them. The taxpayer recognized a loss on the abandonment of the freezer components. The taxpayer must capitalize the amount paid to acquire and install the new freezer components.¹³⁹

In Example 2, a taxpayer’s office building incurs storm damage and the taxpayer claims a casualty loss and reduces the building’s basis. The taxpayer must capitalize the cost of repairs.¹⁴⁰ Similarly, if the taxpayer received insurance proceeds which reduced his basis, the cost or repairs must also be capitalized.¹⁴¹ Amounts paid to restore a building that was not in use because it was in a state of disrepair must be likewise capitalized.¹⁴²

Amounts paid to restore property during the period a taxpayer reasonable believed the property would be useful to him may be currently deducted. In Examples 6 and 7, it is assumed a rail carrier rebuilds a railroad freight car having a recovery period of seven years and an actual useful life to the taxpayer of 30 years. If the rail carrier incurs this expense in the 10th year of service, the amount may be deducted currently. If the expenditures is incurred the 40th year of service, the proposed regulations provide that the expenditures must be capitalized, since the expenditure was incurred after the expiration of the useful life period to the taxpayer, 30 years.¹⁴³

In Example 8, a taxpayer who owns a truck replaces the engine and cab at a cost of \$25,000. The cost of a new truck is \$50,000. The taxpayer must capitalize the cost of the engine and cab because it is 50 percent or more of the replacement asset.¹⁴⁴

E. Amounts Paid to Adapt Property to Different Use

Taxpayers must capitalize expenditures that are made for the purposes of adapting a unit of property to a different use. An amount is paid "to adapt a property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time originally placed in service by the taxpayer."¹⁴⁵

For example, a taxpayer owns property that was operated as a manufacturing facility. The taxpayer decides to sell the property to a developer that intends to use the property for residential property. The taxpayer spends money to clean up waste that was discharged on the property. The taxpayer also re-grades the property so that it could be used for residential purposes. The amount expended to clean up the waste did not adapt the property for a different use and, therefore, is not capitalized. However, the amount expended to re-grade the property was incurred to adapt the property to a different use, residential property, from its originally intended use, manufacturing, and, therefore, must be capitalized.¹⁴⁶

F. Safe Harbor for Routine Maintenance

Routine maintenance performed on a unit of property will be treated as though it does not improve property. As such, it may currently be deducted. Routine maintenance is a recurring activity if the taxpayer expects to perform the activity more than once during its class life. Routine maintenance includes inspecting, cleaning and testing of the unit of property. The proposed regulations provide that the following factors must be considered in determining whether a taxpayer performed routine maintenance: recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience and the taxpayer's treatment of the activity on its applicable financial statement.¹⁴⁷

An example in the proposed regulation closely resembles the facts in *FedEx Corp.*¹⁴⁸ and, contrary to the IRS' position in that case, holds the expenses incurred by a commercial airline for regular engine shop visits were currently deductible. The engine shop visits included the disassembly, cleaning, inspecting, repairing, replacement, reassembly and testing of the engines. The engine shop visits were required every four years, and the aircraft had a

class life of 12 years. As such, the maintenance was a recurring activity which did not improve the aircraft and were not required to be capitalized.¹⁴⁹ Expenditures incurred for engine shop visits after the expiration of the economic useful life of the plane were deemed not to improve the aircraft and do not have to be capitalized.¹⁵⁰

The preamble to the proposed regulations provides that the rules are intended to be safe harbor: "The IRS and Treasury Department recognize that many activities that do not qualify for the safe harbor nonetheless may be activities that do not give rise to capitalization of costs under Code Sec. 263(a)."¹⁵¹

G. Repair Allowance

Unlike the first set of proposed regulations, which contained a repair allowance, the second set of proposed regulations issued in March 2008 does not provide a repair allowance. Comments received in response to the issuance of the first set of proposed regulations issued in 2006 proposed regulations generally favored the idea of repair allowances but criticized the "one-size-fits-all approach."¹⁵²

It is anticipated that the IRS and the Treasury will provide guidance on repair allowances for various industries. The proposed regulations provides that a taxpayer may use a repair allowance that is identified in the Federal Register or in an Internal Revenue Bulletin.¹⁵³

H. De Minimis Exception

The first set of proposed regulations did not contain a *de minimis* rule. In the preamble to the first set of proposed regulations, the IRS requested public comment on whether the regulations should contain a *de minimis* exception. It also acknowledged that IRS agents in practice permit taxpayers to use a capitalization policy that incorporates a *de minimis* exception:

The proposed regulations do not include a *de minimis* rule for acquisition costs. However, the IRS and the Treasury Department recognize that taxpayers often reach an agreement with IRS examining agents that, as an administrative matter, based on risk analysis and/or materiality, the IRS examining agents do not select certain items for review such as the acquisition of tangible assets with a small cost. This often is referred to by taxpayers and IRS examining agents as a *de*

minimis rule. The absence of a *de minimis* rule in the proposed regulations is not intended to change this practice.¹⁵⁴

The U.S. Court of Federal Claims in *Cincinnati, New Orleans & Texas Railway Co.*¹⁵⁵ has upheld the taxpayer's method of accounting under which it expensed all expenditures that did not exceed \$500. The accounting method of the taxpayer, a rail carrier's, conformed to the capitalization policy required by the Interstate Commerce Commission. However, the Tax Court in *Alacare Health Services* rejected a taxpayer's accounting method, which expensed equipment costing less than \$500 where there was no showing that the method clearly reflected the taxpayer's income. The Tax Court, in distinguishing its case with those of the U.S. Courts of Federal Claims, noted there were significant differences in the statistical data of the taxpayers.¹⁵⁶ Section IV.C of this article discusses these cases in greater detail.

Both the proposed regulations for materials and supplies, Proposed Reg. §1.162-3, and capitalization, Proposed Reg. §1.263, contain *de minimis* exceptions. As previously discussed in Section V.C of this article, the definition of materials and supplies includes "tangible property that is used or consumed in the taxpayer's operation" and is a unit of property that has an acquisition cost or production cost of \$100 or less.¹⁵⁷ For example, a business that engages in the rental of tangible personal property can expense as materials and supplies the purchase of rental property in the year it is placed in service if the cost of such property is less than \$100.¹⁵⁸

The proposed capitalization regulations also provide that a taxpayer is not required to capitalize amounts paid to acquire or produce a unit of property if (1) the taxpayer has an applicable financial statement¹⁵⁹; (2) the taxpayer has adopted a written accounting procedure that adopts a *de minimis* exception for capitalization for non-tax purposes; (3) the taxpayer treats the amount paid on its applicable financial statement as an expense, and (4) the total amount expensed does not distort the taxpayer's income for the year.¹⁶⁰

The proposed regulations contain a safe harbor test for determining whether the amount expensed under the taxpayer's written *de minimis* expenditure policy will be deemed to distort a taxpayer's income. An expenditure which does not exceed an amount computed under the proposed regulation formula will not be deemed to distort the taxpayer's income. The taxpayer will be deemed to meet this

safe harbor if the total amount deducted under the *de minimis* rule for materials and supplies for the units of property costing less than \$100 plus the amount expensed under this capitalization rule do not exceed the lesser of:

- 0.1 percent of gross receipts for the tax year; or
- two percent of the taxpayer's total depreciation and amortization expense for the tax year as reported in its applicable financial statement.¹⁶¹

For example, assume taxpayer X purchases 300 computers at a cost of \$400 each, or a total of \$120,000. X has a written policy that it will not capitalize expenditures of under \$500. X expensed the computers on its applicable financial statements. X also purchased 300 desk chairs for \$50 each, or a total of \$15,000. X intends to deduct the desk chairs when they are placed in service since the cost for each chair was under \$100 each. X has gross receipts of \$125 million and reports \$7 million of depreciation expense. To meet the safe harbor, the amount deducted must be less than:

- $0.1\% \times \$125,000,000$, or \$125,000; or
- $2\% \times \$7,000,000$, or \$140,000.

Taxpayer X would not meet the safe harbor because the amount deducted as material and supplies, \$15,000, plus the amount deducted under the *de minimis* capitalization policy, \$120,000, total \$135,000 which exceeds \$125,000. Notwithstanding the fact that X does not meet the safe harbor test, X could expense the amount if he could demonstrate that its capitalization policy does not distort income.¹⁶²

If X in the foregoing example elected to capitalize 25 of the 300 computers, it would meet the safe harbor test. X would expense 275 computers each having a cost of \$400, or a total of \$110,000, plus the desk chairs, \$15,000. Now, the total amount expensed, \$125,000, does not exceed \$125,000, so X meets the safe harbor test.¹⁶³

A taxpayer can elect to capitalize an expenditure that would otherwise meet the *de minimis* exception. The election is made by treating the amount paid as a capital expenditure in the taxpayer's timely filed Federal income tax return.¹⁶⁴

Upon the disposition of an asset expensed under the *de minimis* rule, the taxpayer will realize ordinary gain. The proposed regulation provides that a taxpayer will not treat such gain as arising from a capital transaction or from an asset used in a trade or business.¹⁶⁵

I. Optional Regulatory Accounting Method

The proposed regulations contain a provision that taxpayers in a regulated industry may elect to apply for federal tax purposes the accounting method that it uses for regulatory accounting purposes. A taxpayer who makes this election must use the regulatory accounting principles for determining whether amounts paid to repair, maintain or improve property are capital expenditures or deductible expenses. The proposed regulation identifies taxpayers who are in regulated industries as ones who are subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC) or the Surface Transportation Board (STB).¹⁶⁶

J. Plan of Rehabilitation Doctrine

The proposed regulations provide that as long as repairs and maintenance “do not directly benefit or are incurred by reason of an improvement,” they do not have to be capitalized even though they are made at the time of improvement. However, the regulation further states that a taxpayer must capitalize all direct costs of improvements and indirect costs that directly benefit or are incurred by reason of the improvement under the uniform capitalization rules.¹⁶⁷

The preamble to the proposed regulations state that, as a result of these changes, “the judicially-created plan of rehabilitation doctrine will be obsolete, particularly with regard to the assertion that the doctrine transform otherwise deductible repair costs into capital improvement costs solely because the repairs are performed at the same time as an improvement, or are pursuant to a maintenance plan, even though the repairs do not improve the property.”¹⁶⁸

VI. Summary and Conclusion

The proposed regulations, if they become final, will certainly provide taxpayers additional guidance as to the IRS’ position as to whether certain expenditures should be capitalized and have its cost recovered over a period of years as depreciation deductions, or instead be currently expensed as maintenance or repairs. They also create a number of safe harbor rules that should eliminate a significant amount of controversy.

The proposed regulations contain two *de minimis* tests. If taxpayers meet either of these tests, capitalization will not be required. First, the definition of

materials and supplies includes units of property used in a taxpayer’s business that have a cost of \$100 or less.¹⁶⁹ Second, taxpayers are not required to capitalize expenditures which are classified as *de minimis* pursuant to a written policy of the taxpayer, and such outlays are also treated as an expense on the taxpayer’s applicable financial statement; provided that the total amount classified as *de minimis* expenses does not distort the taxpayer’s income.¹⁷⁰

The proposed regulations contain a number of bright line tests that should provide taxpayers a fair amount of certainty. By meeting or failing the particular test, taxpayers should have some degree of assurance as to whether they will be required to capitalize certain expenditures. Expenditures that in aggregate do not exceed the lesser of a specified percentage of the taxpayer’s annual gross receipts or its depreciation deduction will not be deemed to distort the taxpayer’s income for the purpose of determining whether certain expenditures qualify for the *de minimis* exception.¹⁷¹ Taxpayers that have recognized gain or loss when property is damaged from casualty, or upon the disposition of property, generally cannot deduct the cost of restoration or replacement. Nor can taxpayers deduct currently outlays which return property from a state of disrepair to operational.¹⁷² Expenditures which meet the definition of routine maintenance will be currently deductible.¹⁷³

The proposed regulations, should they become final, will not eliminate all capitalization issues. A taxpayer’s accounting policy does not have to comply with the proposed regulations provided that the taxpayer can demonstrate that its accounting policy clearly reflects its income. However, if the IRS asserts that the taxpayer’s method does not clearly reflect income, the taxpayer has the burden to demonstrate that the IRS abused its discretion.¹⁷⁴ If the taxpayer establishes that its method of accounting clearly reflects its income, the IRS should not prevail even if its method more clearly reflects income.¹⁷⁵

For example, assume a taxpayer own an apartment complex containing 350 separate dwelling units. In the year of acquisition, the taxpayer elects to treat each apartment building, including all of its contents, as the unit of property. The taxpayer allocated the entire acquisition cost to land and buildings. As such, the taxpayer depreciated the entire acquisition cost allocated to the building over 27 1/2 years on a straight-line basis. Since no amounts were allocated to personal property, no portion of the purchase price was recovered over a five-year recovery period. Upon replacement of any component within the apartment

complex (such as a refrigerator, stove, carpeting, etc.) the taxpayer expensed the cost of the purchase. The taxpayer concludes that under its interpretation of the unit of property, *i.e.*, the building, the replacement of the appliances and carpeting did not result in a betterment of the property, restore the building, or adapt the building to a new or different use.¹⁷⁶ Thus, it deducted, rather than capitalized, the cost of all appliances and carpeting the year they were placed in service.¹⁷⁷ The taxpayer elected this method of capitalization because it significantly decreases the administrative burden of accounting for all the separate items of tangible personal property within an apartment including stoves, refrigerators, air conditioners, carpeting, etc.

The taxpayer accounting method does not conform to the proposed regulations which provide that tangible property located in a building are separate units of property.¹⁷⁸ The capitalization method selected by the taxpayer raises the issue of whether it clearly reflects its income, and is thus an acceptable accounting method.

As a result of the taxpayer's decision to treat the entire complex as the unit of property, the taxpayer's depreciation deductions in the initial years im-

mediately following the purchase of the apartment complex will be less than they would have been if the taxpayer allocated a portion of the purchase price to the acquisition of tangible property. Since the taxpayer treats the apartment building as the unit of property, the entire purchase price will be allocated to land and to depreciable residential property. The portion of the purchase price allocated to depreciable residential property will be recovered on a straight line basis over 27 1/2 years.¹⁷⁹ To the extent a portion of the purchase price had been allocated to appliances and carpeting, it would be classified as five-year recovery property and recovered using accelerated method of depreciation over the five-year period.¹⁸⁰ Since the taxpayer is deducting its initial cost of the tangible property over 27 1/2 years rather than five years, even though the taxpayer later expensed the replacement components when placed in service, the net tax effect to the taxpayer may be *de minimis*. After taking into account the actual tax savings, if any, to the taxpayer, and the administrative burdens of accounting for each separate unit of property, the taxpayer's method of accounting may be deemed to clearly reflect its income.

ENDNOTES

¹ Code Secs. 167, 168. A taxpayer who meets certain conditions can elect to expense, rather than capitalize, the cost of acquiring tangible personal property that is for use in the active conduct of a trade or business. Code Sec. 179.

² *Welch v. Helvering*, SCT, 3 USTC ¶1164, 290 US 111 (1933).

³ *Libby & Blouin, Ltd.*, BTA, 4 BTA 910 (Dec. 1637) (1926).

⁴ *W.A. Stoeltzing*, CA-3, 59-1 USTC ¶9444, 266 F2d 374, 376, *aff'd*, 17 TCM 567, Dec. 23,033(M), TC Memo. 1958-111.

⁵ *Dominion Resources, Inc.*, CA-4, 2000-2 USTC ¶50,633, 219 F3d 359, *citing J.M. Jones*, CA-5, 57-1 USTC ¶9517, 242 F2d 616.

⁶ *United Dairy Farmers, Inc.*, CA-6, 2001-2 USTC ¶50,680, 267 F3d 510; *Libby & Blouin, Ltd.*, *supra* note 3.

⁷ Rev. Proc. 97-27, 1997-1 CB 680, §2.01(1).

⁸ Code Sec. 446 (a).

⁹ *Kroger Co.*, 73 TCM 1637, Dec. 51,803(M), TC Memo. 1997-2. See also *Ansley-Sheppard-Burgess Co.*, 104 TC 367 (1995); *Bank One Corp.*, 120 TC 174, Dec. 55,138 (2003).

¹⁰ The Government lost in *Federal Ex Corp.*, DC-TN, 2003-2 USTC ¶50,697, 291 FSupp2d 699, *aff'd*, CA-6, 2005-1 USTC ¶50,186, 412 F3d 617; and *Ingram Industries, Inc.*, 80TCM 532, Dec. 54,088(M), TC Memo. 2000-323. The government prevailed in *R.L. Smith*, CA-9, 2002-2 USTC ¶50,583, 300 F3d 1023 (2002).

¹¹ *Federal Ex Corp.*, *supra* note 10.

¹² Notice 2004-6, IRB 2004-3, Jan. 20, 2004.

¹³ First paragraph of Notice 2004-6, *id.*

¹⁴ Preamble to Proposed Reg. §1.162-4, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2 and §1.263(a)-3, issued on Aug. 18, 2006.

¹⁵ Preamble to proposed amendments to Reg. §1.162-4, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2 and §1.263(a)-3, issued on Aug. 18, 2006.

¹⁶ The Treasury and the IRS on March 7, 2008, issuing a preamble and proposed amendments to Reg. §1.162-3, §1.162-4, §1.162-6, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2, §1.263(a)-3 and §1.263A-1, and withdrawing previously issued proposed regulations.

¹⁷ Code Sec. 446 (a).

¹⁸ Reg. §1.446-1(a)(4).

¹⁹ See *Sunoco, Inc.*, 87 TCM 937, Dec. 55,533(M), TC Memo. 2004-29; and *J.C. Patchen*, CA-5, 58-2 USTC ¶9733, 258 F2d 544.

²⁰ Code Sec. 446(b).

²¹ Reg. §1.446-1(a)(2).

²² Reg. §1.446-1(e). A taxpayer who wants to change an accounting method will file Form 3115, *Application for Change in Accounting Method*, with the IRS. The application must be completed with all the required information and the taxpayer must agree to all the terms and conditions prescribed by the IRS, including the Code Sec. 481 adjustment. Reg. §1.446-1(e)(3)(i). Code Sec. 481

requires a taxpayer to make an adjustment to report additional income or expenses that would have been reported in prior years before the year of change if the taxpayer had been on the new method in those prior years. See Rev. Proc. 2007-11, IRB 2007-4, 358, for automatic consent procedures for depreciation and amortization.

²³ *Brookshire Brothers Holding Inc.*, CA-5, 2003-1 USTC ¶50,214, 320 F3d 507.

²⁴ *E. Marandola, Jr.*, FedCl, 2007-1 USTC ¶50,445, 76 FedCl 237.

²⁵ Reg. §1.446-1(e)(2)(ii).

²⁶ Rev. Proc. 97-27, 1997-1 CB 680, §2.01(1).

²⁷ Reg. §1.446-1(e)(2)(ii)(d).

²⁸ Code Sec. 446(b); Reg. §1.446-1(c)(1)(ii)(C).

²⁹ Reg. §1.446-1(c)(1)(ii)(C).

³⁰ Rev. Rul. 90-38, 1990-1 CB 57, *citing Diebold, Inc.*, CA-FC, 90-1 USTC ¶50,003, 891 F2d 1579.

³¹ Rev. Rul. 90-38, 1990-1 CB 57, *citing* Reg. §1.446-1(e)(1).

³² *Travelers Insurance Co.*, CA-FC, 2002-2 USTC ¶50,652, 303 F3d 1373 (2002).

³³ *JP Morgan Chase & Co.*, CA-7, 2006-2 USTC ¶50,453, 458 F3d 564, *Kroger Co.*, *supra* note 9.

³⁴ *JP Morgan Chase & Co.*, *id.*

³⁵ *Kroger Co.*, *supra* note 9. See also *Ansley-Sheppard-Burgess Company*, *supra* note 9; *Bank One Corp.*, *supra* note 9.

³⁶ *Anschutz Co.*, 91 TCM 860, Dec. 56,446(M), TC Memo. 2006-40; *H.C. Haynes, Inc.*,

- 88 TCM 122, Dec. 55,720(M), TC Memo. 2004-185.
- ³⁷ *Cincinnati, New Orleans & Texas Pacific Railway Co.*, CtClS, 70-1 USTC ¶9344, 424 F2d 563.
- ³⁸ Former Code Sec. 24 (a)(2) was the predecessor to current Code Sec. 263.
- ³⁹ Reg. §111, which was the predecessor to Reg. §1.263(a)-2(a).
- ⁴⁰ Code Sec. 263(a).
- ⁴¹ Reg. §1.263(a)-2(a).
- ⁴² Reg. §1.263(a)-1(b).
- ⁴³ Reg. §1.162-4.
- ⁴⁴ *R.K. Walling Est.*, CA-3, 67-1 USTC ¶9238, 373 F2d 190. The case concerned repairs made to barges by a partnership. After the repairs were made, the partnership sold the barges to a corporation that was substantially owned by the partners of the partnership. As part of the contract for sale, the partnership was obligated to pay for the repairs. The partnership deducted the cost of the repairs. The Third Circuit held that the partnership could deduct the repairs to the extent they were necessary to the operation of the barges even though the partnership was no longer operating them. See also *R.L. Smith*, CA-9, 2002-2 USTC ¶50,583, 300 F3d 1023, 1029, note 9; *Cinergy Corp.*, FedCl, 2003-1 USTC ¶50,302, 55 FedCl 489, 517; *Norwest Corp.*, 108 TC 265, 279 (1997).
- ⁴⁵ *J.S. Moss*, CA-9, 87-2 USTC ¶9590, 831 F2d 833, 835.
- ⁴⁶ Where a repair which is part of a plan of rehabilitation it may have to be capitalized. See Section IV of this article, and *W.J. Wehrli*, CA-10, 68-2 USTC ¶9575, 400 F2d 686, 689.
- ⁴⁷ *Cinergy Corp.*, supra note 44.
- ⁴⁸ *Plainfield-Union Water Co.*, 39 TC 333, 337, Dec. 25,740 (1962).
- ⁴⁹ *Cinergy Corp.*, supra note 44.
- ⁵⁰ *R.K. Walling Est.*, supra note 44.
- ⁵¹ *Dominion Resources, Inc.*, CA-4, 2000-2 USTC ¶50,633, 219 F3d 359.
- ⁵² Reg. §1.162-4. Emphasis added.
- ⁵³ *FedEx Corp.*, DC-TN, 2003-2 USTC ¶50,697, 291 FSupp2d 699, *aff'd*, CA-6, 2005-1 USTC ¶50,186, 412 F3d 617.
- ⁵⁴ *Dominion Resources, Inc.*, supra note 50.
- ⁵⁵ *S.B. Scallen*, 54 TCM 177, Dec. 44,131(M), TC Memo. 1987-412.
- ⁵⁶ *J.S. Moss*, 51 TCM 742, Dec. 42,962(M), TC Memo. 1986-128.
- ⁵⁷ See also *Bloomfield Steamship Co.*, 33 TC 75, 84 (1959), where the Tax Court stated, "Incidental" imports that the repairs be necessary to some other action" and *Conroe Office Building, Ltd.*, 61 TCM 2655, Dec. 47,356(M), TC Memo. 1991-224.
- ⁵⁸ *Bloomfield Steamship Co.*, *id.*
- ⁵⁹ *Bank of Houston*, 19 TCM 589, Dec. 24,204(M), TC Memo. 1960-110.
- ⁶⁰ *Plainfield-Union Water Co.*, supra note 48.
- ⁶¹ Reg. §1.263(a)-1(b).
- ⁶² *FedEx Corp.*, supra note 53.
- ⁶³ *Ingram Industries, Inc.*, 80 TCM 532, Dec. 54,088(M), TC Memo. 2000-323.
- ⁶⁴ *R.L. Smith*, CA-9, 2002-2 USTC ¶50,583, 300 F3d 1023.
- ⁶⁵ Footnote 10 of *FedEx Corp.*, supra note 53, which referenced Reg. §1.263A-10(c).
- ⁶⁶ *FedEx Corp.*, supra note 53.
- ⁶⁷ *Ingram Industries, Inc.*, supra note 63.
- ⁶⁸ *Smith*, supra note 64.
- ⁶⁹ The regulations were drafted as part of the uniform capitalization rules set forth in Code Sec. 263A.
- ⁷⁰ Footnote 10 of *FedEx Corp.*, supra note 53.
- ⁷¹ Reg. §1.263A-10(c).
- ⁷² *Ingram Industries, Inc.*, supra note 63.
- ⁷³ *Smith*, supra note 64.
- ⁷⁴ Property that is classified as plant property must treat as separate units of property, each unit that performs a distinct function. Proposed Reg. §1.263(a)-3(d)(2)(iii)(B).
- ⁷⁵ Proposed Reg. §1.263(a)-3(d)(2)(iii).
- ⁷⁶ *Cincinnati, New Orleans & Texas Pacific Railway Co.*, supra note 37.
- ⁷⁷ No explanation is given why the IRS adopted a \$100 *de minimis* rule.
- ⁷⁸ Section 24(a)(2) of the 1939 Code was the predecessor to current Code Sec. 263.
- ⁷⁹ Reg. §111, which is the predecessor to Reg. §1.263(a)-2(a).
- ⁸⁰ Section 41 of the 1939 Code, which is the predecessor to Code Sec. 446.
- ⁸¹ Reg. §29.41-3, which is now Reg. §1.446-1(a)(2).
- ⁸² Reg. §1.263(a)-2(a).
- ⁸³ *Union Pacific Railroad Co.*, CtClS, 76-1 USTC ¶9308, 524 F2d 1343.
- ⁸⁴ *Alacare Home Health Services, Inc.*, 81 TCM 1794, Dec. 54,378(M), TC Memo. 2001-149.
- ⁸⁵ FSA 910, Vaughn No. 910.
- ⁸⁶ CCA 199952010 (Sept. 29,1999).
- ⁸⁷ See *D.C. Rutenbergl*, 52 TCM 370, Dec. 43,323(M), TC Memo. 1986-414, which held that the rehabilitation doctrine applied and the amounts incurred to renovate newly acquired apartment building had to be capitalized. See *I.M. Cowell*, 18 BTA 997, 1002, Dec. 5794 (1930) where the court stated, "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, as here, be properly capitalized when involved in a greater plan of rehabilitation, enlargement and improvement of the entire property"; see also *W.A. Stoeltzing*, CA-3, 59-1 USTC ¶9,444, 266 F2d 374; *J.M. Jones*, 24 TC 563 (1955); *E.M. Cox*, 17 TC 1287 (1952); *Coca-Cola Bottling Works*, 19 BTA 1055, Dec. 6072 (1930); *Home News Publ'g Co.*, 18 BTA 1008, Dec. 5791 (1930).
- ⁸⁸ *Wehrli*, supra note 46.
- ⁸⁹ *Id.*, at 689.
- ⁹⁰ *Id.*, at 690.
- ⁹¹ *Moss*, supra note 46.
- ⁹² *Id.*, at 839.
- ⁹³ *Id.*, at 841.
- ⁹⁴ *Norwest Corp.*, supra note 44.
- ⁹⁵ *Id.*, at 285.
- ⁹⁶ *Cinergy Corp.*, supra note 44.
- ⁹⁷ *H.S. Schroeder*, 72 TCM 185, Dec. 51,463(M), TC Memo. 1996-336.
- ⁹⁸ See *H.A. True, Jr.*, CA-10, 90-1 USTC ¶50,062, 894 F2d 1197, where the Tenth Circuit held that the District Court erred in not giving a plan of rehabilitation jury instruction in determining whether expenses should be capitalized; and *Vanalco*, 78 TCM 251, Dec. 53,493(M), TC Memo. 1999-265 (*R.L. Smith*), where the Tax Court did not apply the plan of rehabilitation doctrine. Roof repairs were not part of a continuous process of roof rebuilding and were not done in preparation or as part of a remodeling project.
- ⁹⁹ Rev. Rul. 2001-4, 2001-1 CB 295.
- ¹⁰⁰ Preamble to proposed amendments to Reg. §1.162-4, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2 and §1.263(a)-3.
- ¹⁰¹ The Treasury and the IRS on March 7, 2008, issuing a preamble and proposed amendments to Reg. §1.162-3, §1.162-4, §1.162-6, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2, §1.263(a)-3 and §1.263A-1, and withdrawing previously issued Proposed Regulations. 73 FR 47, at 12837.
- ¹⁰² Preamble to proposed amendments to Reg. §1.162-3, §1.162-4, §1.162-6, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2, §1.263(a)-3, §1.263A-1. 73 FR 47, at 12837.
- ¹⁰³ Proposed Reg. §1.263(a)-3(d)(1). Emphasis added.
- ¹⁰⁴ Preamble to proposed amendments to Reg. §1.162-3, §1.162-4, §1.162-6, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2, §1.263(a)-3, §1.263A-1, 73 FR 47, at 12837, 12847.
- ¹⁰⁵ Preamble to proposed amendments to Reg. §1.162-3, §1.162-4, §1.162-6, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2, §1.263(a)-3, §1.263A-1, 73 FR 47, at 12837, 12842.
- ¹⁰⁶ The preamble to the proposed amendment to the regulations stated that this rule is consistent with established law citing *United Dairy Farmers, Inc.*, CA-6, 2001-2 USTC ¶50,680, 267 F3d 510, *Dominion Resources, Inc.*, CA-4, 2000-2 USTC ¶50,633, 219 F3d 359.
- ¹⁰⁷ Proposed Reg. §1.263(a)-3(f)(1).
- ¹⁰⁸ Proposed Reg. §1.263(a)-3(f)(2)(i).
- ¹⁰⁹ Proposed Reg. §1.263(a)-3(f)(2)(iii)(A).
- ¹¹⁰ Proposed Reg. §1.263(a)-3(f)(2)(iii)(B). The IRS now apparently accepts the standard set forth in a case to which it previously issued its nonacquiescence. *Plainfield-Union Water Co.*, supra note 48.
- ¹¹¹ Proposed Reg. §1.263(a)-3(f)(3), Example 9.
- ¹¹² Proposed Reg. §1.263(a)-3(h)(1). For example, a manufacturer who converts a manufacturing facility into a showroom must capitalize the expenditures. Proposed Reg. §1.263(a)-3(h)(2), Example 1.
- ¹¹³ Proposed Reg. §1.263(a)-1(b). See Reg. §1.263 A-1(e)(3)(ii); *Idaho Power Co.*, SCT, 74-2 USTC ¶9521, 418 US 1.
- ¹¹⁴ Proposed Reg. §1.263(a)-3(d)(2)(ii).

- ¹¹⁵ *Id.*
- ¹¹⁶ Reg. §1.48-1(e)(1).
- ¹¹⁷ Reg. §1.48-1(e)(2).
- ¹¹⁸ Proposed Reg. §1.263(a)-3(d)(2)(iv), Examples 1 and 2.
- ¹¹⁹ Proposed Reg. §1.263(a)-3(d)(2)(iii).
- ¹²⁰ Proposed Reg. §1.263(a)-3(d)(2)(iii)(A).
- ¹²¹ Proposed Reg. §1.263(a)-3(d)(2)(iii)(D).
- ¹²² Proposed Reg. §1.263(a)-3(d)(2)(iii)(B).
- ¹²³ Proposed Reg. §1.263(a)-3(d)(2)(iv), Example 4; see CCA 200827034.
- ¹²⁴ Proposed Reg. §1.263(a)-3(d)(2)(iv), Example 5.
- ¹²⁵ Proposed Reg. §1.162-3, Materials and supplies, which would replace Reg. §1.162-3, Cost of materials.
- ¹²⁶ Proposed Reg. §1.162-3(a); *Universal Marketing Inc.*, 94 TCM 374, Dec. 57,133(M), TC Memo 2007-305.
- ¹²⁷ *Prudential Overall Supply Co.*, 83 TCM 1545, Dec. 54,723(M), TC Memo. 2002-103.
- ¹²⁸ See Proposed Reg. §1.162-3(f), Example 4. Jet fuel purchased by a taxpayer who maintains a fleet of aircraft is deductible in the year in which it is consumed. The jet fuel is a unit of property that has a useful life of less than a year.
- ¹²⁹ See Proposed Reg. §1.162-3(f), Example 5. X operates a rental business. During the year it purchases a large quantity of rental items each having a cost of \$100 or less. X places the rental property in service the following year. The amount paid is treated as material and supplies and is deductible in the following year. Proposed Reg. §1.162-3(f), Example 5.
- ¹³⁰ Proposed Reg. §1.162-3(d).
- ¹³¹ Proposed Reg. §1.162-3(b).
- ¹³² *Id.*
- ¹³³ Proposed Reg. §1.162-3(f), Example 11.
- ¹³⁴ Proposed Reg. §1.162-3(f), Example 1.
- ¹³⁵ Proposed Reg. §1.162-3(f), Example 3.
- ¹³⁶ Preamble to proposed amendment to Reg. §1.162-3, §1.162-4, §1.162-6, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2, §1.263(a)-3, §1.263A-1, 73 FR 47, at 12837, 12845.
- ¹³⁷ Proposed Reg. §1.263(a)-3(g)(2) provides a unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, manufactured or similar status. Economic useful life is the period the property may be reasonably be expected to be useful to the taxpayer.
- ¹³⁸ Proposed Reg. §1.263(a)-3 (g)(1); Proposed Reg. §1.263(a)-3(g)(3) defines a major component or a substantial structural part as the replacement of a part or parts of a unit of property, which comprises 50 percent or more of the replacement cost of the unit of property or 50 percent or more of the physical structure of the unit of property.
- ¹³⁹ Proposed Reg. §1.263(a)-3(g)(4), Example 1.
- ¹⁴⁰ Proposed Reg. §1.263(a)-3(g)(4), Example 3.
- ¹⁴¹ Proposed Reg. §1.263(a)-3(g)(4), Example 4.
- ¹⁴² Proposed Reg. §1.263(a)-3(g)(4), Example 5.
- ¹⁴³ Proposed Reg. §1.263(a)-3(g)(4), Examples 6 and 7.
- ¹⁴⁴ Proposed Reg. §1.263(a)-3(g)(4), Example 8.
- ¹⁴⁵ Proposed Reg. §1.263(a)-3(h)(1).
- ¹⁴⁶ Proposed Reg. §1.263(a)-3(h)(2), Example 4.
- ¹⁴⁷ Proposed Reg. §1.263(a)-2(e).
- ¹⁴⁸ *Federal Ex Corp.*, *supra* note 10.
- ¹⁴⁹ Proposed Reg. §1.263(a)-2(e)(5), Example 1.
- ¹⁵⁰ Proposed Reg. §1.263-3(e)(5), Example 2.
- ¹⁵¹ Preamble to proposed amendments to Reg. §1.162-3, §1.162-4, §1.162-6, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2, §1.263(a)-3, §1.263A-1, 73 FR 47, at 12837, *et. seq.*
- ¹⁵² Preamble to Reg. §1.162-3, §1.162-4, §1.162-6, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2, §1.263(a)-3, §1.263A-1, 73 FR 47, at 12837, *et. seq.*
- ¹⁵³ Proposed Reg. §1.263(a)-3(j).
- ¹⁵⁴ Preamble to proposed amendments to Reg. §1.162-4, §1.263(a)-1, §1.263(a)-2, and §1.263(a)-3, 71 FR 161 (Aug. 18, 2006).
- ¹⁵⁵ *Cincinnati, New Orleans & Texas Pacific Railway Co.*, *supra* note 37. See also *Union Pacific Railroad Co.*, CtClS, 76-1 USTC ¶9308, 524 F2d 1343.
- ¹⁵⁶ *Alacare Health Services, Inc.*, 81 TCM 1794, Dec. 54,378(M), TC Memo. 2001-149.
- ¹⁵⁷ Proposed Reg. §1.162-3(d)(iii).
- ¹⁵⁸ See Proposed Reg. §1.162-3(f), Example 5.
- ¹⁵⁹ An applicable financial statement is defined in descending order: (1) a financial statement required to be filed with the Security Exchange Commission; (2) a certified audited financial statement accompanied by the report of an independent CPA for credit purposes, reporting to shareholders, or other non-tax purposes; or (3) a financial statement required to be provided to the federal or a state government or any federal or state agencies. Proposed Reg. §1.263(a)-2(d)(4)(iv).
- ¹⁶⁰ Proposed Reg. §1.263(a)-2(d)(4)(i).
- ¹⁶¹ Proposed Reg. §1.263(a)-2(d)(4)(iii).
- ¹⁶² Proposed Reg. §1.263(a)-2(d)(4)(vii), Example 2.
- ¹⁶³ Proposed Reg. §1.263(a)-2(d)(4)(vii), Example 3.
- ¹⁶⁴ Proposed Reg. §1.263(a)-2(d)(4)(v).
- ¹⁶⁵ Proposed Reg. §1.263(a)-2(d)(4)(iv).
- ¹⁶⁶ Proposed Reg. §1.263(a)-3(i).
- ¹⁶⁷ Proposed Reg. §1.263(a)-3(d)(4)(i).
- ¹⁶⁸ Preamble to amendment to Reg. §1.162-3, §1.162-4, §1.162-6, §1.263(a)-0, §1.263(a)-1, §1.263(a)-2, §1.263(a)-3, §1.263A-1.
- ¹⁶⁹ See Section V.C of this article, and Proposed Reg. §1.162(a)-3(d).
- ¹⁷⁰ See Section V.H of this article, and Proposed Reg. §1.263(a)-2(d)(4).
- ¹⁷¹ See Section V.H of this article, and Proposed Reg. §1.263(a)-2(d)(4)(iii).
- ¹⁷² See Section V.D of this article, and Proposed Reg. §1.263(a)-3(g)(1).
- ¹⁷³ See Section V.F of this article, and Proposed Reg. §1.263(a)-2(e).
- ¹⁷⁴ *JP Morgan Chase & Co.*, *supra* note 33; *Kroger Co.*, *supra* note 9.
- ¹⁷⁵ *Kroger Co.*, *supra* note 9. See also *Ansley-Sheppard-Burgess Company*, *supra* note 9; and *Bank One Corporation*, *supra* note 9.
- ¹⁷⁶ Proposed Reg. §1.263(a)-3(d)(1).
- ¹⁷⁷ Note that the taxpayer's method of accounting for assets is significantly different from a taxpayer who capitalizes the original purchase of appliances, furniture and carpeting and expenses the replacement of these items. The replacement of these assets was more than mere incidental repair or maintenance it was the acquisition of a new unit of property. See *J.J. Otis*, 73 TC 671, Dec. 36,716 (1980), *aff'd by court order*, CA-9, 665 F2d 1053 (1981).
- ¹⁷⁸ Proposed Reg. §1.263(a)-3(d)(2)(iv), Examples 1 and 2.
- ¹⁷⁹ Code Sec. 168(c).
- ¹⁸⁰ Tangible property is depreciated on the double declining method over its class life over its applicable recovery period, which is five years for property classified as five-year property. See IRS Announcement 99-82, 1999-2 CB 244, property used in residential property is five-year property.

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