OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MIDWEST ASSOCIATE DISTRICT COUNSEL
CC:MSR:MWD:OMA

FROM: ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated 11/6/98. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

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ISSUES:

1. Can Taxpayer elect the repair allowance provision of Treas. Reg. § 1.167(a)-11(d) of the Asset Depreciation Range system ("ADR") pursuant to Internal Revenue Code section 263(f) (redesignated section 263(e)) without applying any of the other ADR provisions set forth in the Treas. Reg. section 1.167 regulations?
2. Does taxpayer's record keeping practices comport with the requirements of the regulations?
3. Has Taxpayer's non-compliance with various regulations risen to the level of substantial noncompliance such that its election under these regulations is invalidated?
4. Is retirement of equipment for book purposes under Interstate Commerce Commission ("ICC") rules and regulations equivalent to retirement for purposes of ADR, such that Taxpayer could not deduct the cost of overhauling and/or rebuilding the equipment because it has retired it for ICC purposes?

CONCLUSION:

1. No. The regulatory scheme anticipates that a taxpayer utilizing any of the ADR provisions will be subject to all the requirements of the regulations.
2. On the facts presented to us, the taxpayer has not fully complied with all of the regulatory requirements. However, further factual development on this issue is needed.
3. Notwithstanding that the taxpayer has not shown substantial compliance with the regulations, there are litigation hazards involved with asserting that the taxpayer has not substantially complied.
4. There is no basis under the regulations to enforce compliance with ICC regulations concerning retirement.

FACTS:

M, has two subsidiaries A and B (collectively referred to as taxpayer). Taxpayer elected the ADR provisions for their C equipment, generally made up of D for most of the years from Date 1 to Date 2, when the elections were available. For all property placed into service after Date 2, taxpayer has utilized the Accelerated Cost Recovery System .

Starting in Date 3, taxpayer elected under Treas. Reg. section 1.167(a)-11(d)(2)(ii) to use the Percentage Repair Allowance available under the ADR provisions for the Date 3, Date 4 and Date 5 years for property that had been placed in service between Date 1 and Date 2. No ADR elections were made for property placed in service after Date 2.

The ADR system, also known as the Class Life Asset Depreciation Range system allows taxpayers to elect to apply its provisions to property placed in service after December 31, 1970 and before January 1. 1981. Although the ADR provisions are no longer in effect, the ADR repair allowance still remains in effect for expenditures for repair, maintenance, rehabilitation, or improvement of property made after December 31, 1980 for property placed into service during the applicable ADR years.

The ADR repair allowance was created as a tool to resolve "the disputes which frequently arise as to whether an item constitutes a deductible repair expense or a nondeductible capital expenditure." United States v. Wisconsin Power and Light Co., 38 F.3d 329, 331 (7th Cir. 1994) (citing H.R. Rep. No. 92-533, 92nd Cong., 1st Sess. 134, 1971-1 C.B. 498, 516; S.Rep. No. 92-437, 92nd Cong., 50, 52, 1972-1 C.B. 559, 587.) Under the repair allowance, a taxpayer "may automatically deduct up to a set percentage of all repair expenditures for the year, except for those expenditures considered 'excluded additions'". Id. at 332; Treas. Reg. § 1.167(a)-11(d)(2)(iv). The percentage is supposed to reflect the anticipated repair experience of a class of property. Any amount which exceeds the repair allowance must be capitalized.

Under the election, A deducted expenditures for E of $X1 in Date 3, $X2 in Date 4 and $X3 in Date 5. A has also relied on this election to deduct expenditures for F of $X4 in Date 3, $X5 in Date 4 and $X6 in Date 5. B deducted expenditures for F of $X7 in Date 3, $X8 in Date 4 and $X9 in Date 4.

The regulations under ADR provide for myriad book keeping rules. Examples of these requirements include: (1) the maintenance of "closed-end vintage accounts"; (2)

allocations of expenses incurred on ADR and non-ADR property; (3) and removal of units retired from the base calculation. As to this last example, the taxpayer used the repair allowance to deduct expenses for substantial rebuilding of L, without treating them as retirements. Under ICC rule 2-12, which applies to taxpayer, these repairs are retirements for book purposes.

Currently this case is in audit and the revenue agent's report has not been issued.

LAW AND ANALYSIS

ISSUE 1: ADR ELECTION UNDER SECTION 263(f)

As a threshold matter, the question must be resolved whether a taxpayer, electing the repair allowance under section 263(f) may apply only those provisions under Treas. Reg. section 1.167 which concern the repair allowance without applying the rest of the class life system set forth under the ADR provisions. If true, an election under section 263(f) would be more narrow than electing the full ADR system and would grant a taxpayer considerable more latitude in its record keeping practices. Section 263(f)[1] is applicable to property placed in service after 1970 and prior to 1981 and provides:

> "REASONABLE REPAIR ALLOWANCE – The Secretary may by regulations provide that the taxpayer may make an election under which amounts representing either repair expenses or specified repair, rehabilitation, or improvement expenditures for any class of depreciable property-
>
> (1) are allowable as a deduction under section 162(a) or 212 (whichever is appropriate) to the extent of the repair allowance for that class, and
>
> (2) to the extent such amounts exceed for the taxable year such repair allowance, are chargeable to capital account.
>
> Any allowance prescribed under this subsection shall reasonably reflect the anticipated repair experience of the class of property in the industry or other group.

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1. Section 263(f) was redesignated section 263(e) on February 2, 1977. In 1981 P.L. 97-34, section 201(c) repealed the repair allowance election under section 263(e) with respect to property placed in service after December 31, 1980. General Explanation of Tax Legislation Enacted in 1981, p. 83.

Section 1.263(f)-1(a) prescribes:

> "For rules regarding the election of the repair allowance authorized by section 263(f), the definition of repair allowance property, and the conditions under which an election may be made, see paragraphs (d)(2) and (f) of section 1.167(a)-11. **An election may be made under this section for a taxable year only if the taxpayer makes an election under section 1.167(a)-11 for such taxable year**." [Emphasis added.]

Therefore, a taxpayer electing the ADR repair allowance is also required to have elected into all the ADR rules found at Treas. Reg. section 1.167(a)-11.

Further, Treas. Reg. section 1.167(a)-11(a) states in part, "**In general, a taxpayer may not apply any provision of this section unless he makes an election and thereby consents to and agrees to apply, all the provisions of this section.**" [Emphasis added.] Accordingly, taxpayer must comply with all of the regulations under Treas. Reg. 1.167 and may not cherry pick the repair allowance provisions alone.

Moreover, it is our understanding that in this specific case, the Taxpayer MADE the election to opt into the ADR regulations. Although it addressed a different issue, TAM 83-11-001 provides: "[T]he election of the repair allowance is, of course, contingent upon the primary election by Taxpayer of the CLADR system of depreciation."

Because we find that taxpayers electing to apply the repair allowance pursuant to section 263(f) must comply with all the ADR regulations we now turn to the question of whether taxpayer failed to comply with the ADR regulations and what is the effect of failure to comply with those regulations.

ISSUE 2: COMPLIANCE WITH ADR REGULATIONS

You have asserted that the taxpayer has not complied with the following regulations:

<u>Excluded Additions</u>

Under Treas. Reg. 1.167(a)-11(d)(2)(iv), expenditures for the repair, maintenance, rehabilitation or improvement of property do not include expenditures for an excluded addition. Excluded addition is defined under subpart (vi) and includes in relevant part:

> (d) An expenditure for an identifiable unit of property if (1) such expenditure is for an additional identifiable unit of property or (2) such expenditure (other than an expenditure described in (e) of this subdivision) is for replacement of an identifiable unit of property which was retired;
>
> (e) An expenditure for replacement of a part in or a component or portion of an existing identifiable unit of property (whether or not such part, component, or portion is also an identifiable unit of property) if such part, component or portion which was retired in a retirement upon which gain or loss is recognized . . .

Therefore, expenditures which result in the replacement of a unit which was retired and those which count as a retirement upon which gain or loss is recognized are excluded additions and hence are not expenditures for the repair, maintenance, rehabilitation or improvement of property which would be subject to the repair allowance. The regulation also provides that expenditures which merely increase the productive life of the asset are not, on that basis alone, excluded.

This definition, then rests upon the further definition of "retirement." The definition of retirement is included at Treas. Reg. 1.167(a)-11(d)(3):

> An asset in a vintage account is retired when such asset is permanently withdrawn from use in a trade or business or in the production of income by the taxpayer. A retirement may occur as a result of a sale or exchange, by other act of the taxpayer amounting to a permanent disposition of an asset, or by physical abandonment of an asset. A retirement may also occur by transfer of an asset to supplies or scrap.

The facts presented to us are that the H are retired for the purposes of the taxpayer's books, have salvage values, and the taxpayer has actually claimed a gain or loss for them. However, for tax purposes the taxpayer shows no gain or loss. It is our understanding that in most cases, the documents authorizing the work to be done state "value of parts reused" or H "rebuilt in this program will be drawn from the unserviceable J - idle and unproductive assets." In both instances, the language refers to assets in such disrepair that they cannot be repaired, have not been used for some time and/or are assets that have been scrapped with part of the scrapped asset salvaged for further use. Some assets are in such a state of disrepair, they cannot be moved to the rebuilding facility and are scrapped on site. The taxpayer accounts for units of property entering rebuild programs on its books as the retirement of the old unit, and a debit to salvage for the parts reused. Then the taxpayer expenses the cost

of the rebuilt unit as an ADR repair allowance. The taxpayer's ADR repair allowance calculation does not reflect these costs as excluded additions.

Nonetheless, the asset is not permanently removed from service and there is no increase in K or productivity of the assets although the expenditures may extend the use of the asset. There has been no sale or exchange, or physical abandonment by the taxpayer.

As a practical matter, the rebuilding process is only a retirement if the L are so extensively rebuilt as to amount to a transferral to supplies or scrap or some "other act" of the taxpayer has amounted to a permanent disposition of the asset. It appears that a transferral to supplies or scrap may have occurred in some cases. However, examples of excluded additions are included at Treas. Reg. 1.167(a)-11(d)(2) and based on the examples, there are significant hazards with arguing that the taxpayer's rebuilding program involves a retirement. The facts that have been presented to us do not fall within the examples listed.[2] Further factual development will be needed to see if the facts fall in line with the examples of retirements. Moreover, despite the book treatment of these assets, as noted in TAM 83-11-001, "neither section 263(e) of the Code or Treas. Reg. section 1.167(a)-11 requires specific conformity with book records."[3]

Repair Allowance Record Keeping

Under Treas. Reg. 1.167(a)-11(d)(2)(v) if taxpayer wishes to utilize the repair allowance it is obliged to maintain books and records reasonably sufficient to determine the amount of expenditures paid or incurred during the taxable year for repair, maintenance, rehabilitation or improvement of repair allowance property and the amount of expenditures which are for excluded additions. Thus, taxpayer's books must be in sufficient detail to identify the amount and nature of expenditures.

This requirement is relaxed where it is not practical to maintain such records, but only to the point where the taxpayer is required to allocate expenditures, by any reasonable method, consistently applied. The regulations at Treas. Reg. 1.167(a)-11(d)(2)(v)(a)(2) provide guidance on when this relaxed accounting is acceptable:

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[2] For instance, under the examples the overhaul of a rail and billet mill with no increased capacity is not a retirement, nor was the replacement of two roof girders in a factory.

[3] When the facts and circumstances do indicate that a retirement has occurred, then a further question must be asked as to whether it is considered an ordinary or extraordinary retirement. See Treas. Regs. §§1.167(a)-11(d)(3)(ii); 1.167(a)-11(d)(3)(v)(b) and 1.1502-13 (rules that apply to intercompany transactions).

> The types of expenditures for which specific identification would ordinarily be made include: Substantial expenditures such as for major parts or major structural materials for which a work order is or would customarily be written; expenditures for work performed by an outside contractor; or expenditures under a specific down time program. Types of expenditures for which specific identification would ordinarily be impractical include: General maintenance costs of machinery, equipment, and plant in the case of a taxpayer having assets in more than one class or different types of assets in the same class) which are located together and generally maintained by the same work crew . . . .

Hence, there are two issues to address under these provisions. The first is that the taxpayer must maintain books sufficient to identify the amount and nature of expenditures with respect to specific items of repair allowance property or groups of similar properties in the same asset guideline class. Specifically, the taxpayer must be able to identify which expenditures were for excluded additions. Based upon the information we have received, taxpayer has no system or written criteria to identify the amount and nature of these expenditures.

Secondly, although the regulation allows allocations where identifying expenditures is not feasible, it specifically distinguishes situations in which such record keeping is required. This includes substantial expenditures such as for major parts or major structural materials. The rebuilding program which taxpayer has engaged in is extensive enough to count as a retirement for I.C.C. rules. The field needs to develop the facts as to exactly what type of repairs the taxpayer performs on its L. On the basis of the facts as presented to us these appear to involve substantial expenditures for major parts or structural materials, but this must be confirmed. Maintaining books as to these expenditures is a requirement.

Based upon our understanding of the case, taxpayer has not kept records of these expenditures nor has it attempted an allocation. Even had the taxpayer attempted an allocation, it still had to be reasonable and consistently applied.

Vintage Account Requirements

Under Treas. Reg. 1.167(a)-11(b)(3)(i) if the taxpayer has elected the ADR provisions the taxpayer is required to maintain vintage accounts which are closed end depreciation accounts containing eligible property, during the taxable year the property was first placed in service by the taxpayer. Each account contains an asset which is

eligible property[4] or a group of assets which are eligible property within a single asset guideline class

Moreover, under subpart (ii) of this subsection, property whose original use does not commence with the taxpayer cannot be placed in a vintage account with property whose original use did commence with the taxpayer. An exception applies to property acquired in a transaction under section 381(a).

Under Treas. Reg. 1.167(a)-11(e)(3)(i), if an acquiring corporation elects to apply the ADR rules to eligible property acquired in a transaction to which section 381(a) applies, then –

> [T]he acquiring corporation must segregate such eligible property (to which the distributor or transferor corporation elected to apply this section) into vintage accounts as nearly coextensive as possible with the vintage accounts created by the distributor or transferor corporation identified by reference to the year the property was first placed in service by the distributor or transferor corporation.[5] The asset depreciation period for the vintage account in the hands of the distributor or transferor corporation must be used by the acquiring corporation. The method of

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4 Eligible property under section 1.167(a)-11(b)(2) is defined:

> For purposes of this section, the term "eligible property" means tangible property which is subject to the allowance for depreciation provided by section 167(a) but only if –
>
> (i) An asset guideline class and asset guideline period are in effect for such property for the taxable year of election (see subparagraph (4) of this paragraph);
>
> (ii) The property is first place in service as described in paragraph (e)(1) of this section) by the taxpayer after December 31, 1970 (but see paragraph (7) of this paragraph for special rule where there is a mere change in the form of conducting a trade or business); and
>
> (iii) The property is either -
>
> (a) Section 1245 property as defined in section 1245(a)(3), or
>
> (b) Section 1250 property . . .

5 Under Treas. Reg. 1.167(a)-11(e)(1) the, "[d]efinition of first placed in service. (i) In general. the term "first placed in service" refers to the time the property is first placed in service by the taxpayer, not to the first time the property is placed in service."

> depreciation adopted by the distributor or transferor corporation, shall be used by the acquiring corporation unless such corporation obtains the consent of the Commissioner to use another method of depreciation. . . .

Upon the facts submitted to us it appears the taxpayer has not maintained closed vintage accounts and has added assets obtained in section 381(a) transfers, without segregating them. In particular the taxpayer has included such property in the current repair allowance calculation without showing that the property was originally covered by an ADR election.

Segregated assets must be kept separate, and not put into the same account as assets with similar vintage account years. If taxpayer has done this then it is not in compliance with the regulation.

Capitalization of Property Improvements, Establishment of Depreciation Reserves & Special Rules for Salvage

Based upon the facts submitted, it appears that the taxpayer has also not complied with the following provisions. Under Treas. Reg. 1.167(a)-11(d)2(viii) property improvements must be capitalized in a special basis vintage account. Even though taxpayer's calculation of the repair allowance for Date 3 identified a property improvement, no property improvement was capitalized.

Under Treas. Reg. 1.167(a)-11(c)(1)(ii) the taxpayer must establish a depreciation reserve for each vintage account. This does not appear to have been done. And finally under Treas. Reg. 1.167(a)-11(d)(1)(iii) the taxpayer must maintain records reasonably sufficient to determine the facts and circumstances taken into account in determining salvage value. It is our understanding that taxpayer's records do not provide sufficient facts to determine salvage value.

Conclusion

In United States v. Wisconsin Power and Light Co., 38 F.2d 329 (7th Cir. 1994) the court dealt with the issue of whether the taxpayer was entitled to deduct replacement expenditures under the ADR system. In upholding the district court's determination that the taxpayer had failed to establish its entitlement to deduct replacement expenditures, the court noted that the burden of showing the right to a deduction is upon the taxpayer. Id. at 337. The figures submitted must carry the necessary reliability to determine the amount to which the taxpayer claims entitlement. Id. Placing the burden upon the service to deduce their entitlement to a deduction is inappropriate.

Thus, further factual development is needed to know whether taxpayer has retired its L and whether its expenditures are excluded additions. In addition, on the facts submitted to us, taxpayer has not maintained sufficient books and records to identify its expenditures and thus prove its entitlement. Taxpayer has not maintained vintage accounts per the regulations, therefore taxpayer may have included ineligible property in its calculations. These facts should be confirmed.

Finally, taxpayer also appears to have not capitalized property improvements, not established a depreciation reserve, and cannot prove how it determined salvage. These requirements are all necessary prerequisites to proving entitlement to the deduction.

ISSUE 3: Substantial Compliance

The issue arises whether taxpayer failed to substantially comply with the regulations requirements to such an extent that the Taxpayer's ADR election has been rendered invalid. The regulations themselves contain a substantial compliance provision at Treas. Reg. 1.167(a)-11(f)(2) which reads:

> A taxpayer who elects to apply this section must specify in the election; (i) that the taxpayer makes such election and consents to and **agrees to apply, all the provisions** of this section . . . An election to apply this section **will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith**, with the requirements of this subparagraph. [Emphasis added.]

In addition, under Treas. Reg. 1.167(a)-11(f)(4): "The taxpayer may not elect to apply this section for a taxable year unless the taxpayer maintains the books and records required under this section." The same subsection reiterates that elections will not be rendered invalid so long as there is substantial compliance in good faith.

Case law construing substantial compliance indicates that it is a fact intensive determination and can turn on the relationship of the provisions not complied with and what the consequences of failure to comply are. In Hewlett-Packard v. Commissioner, 67 T.C. 736,749 (1977) the Tax Court discussed substantial compliance :

> In ascertaining whether a particular provision of a regulation stating how an election is to be made must be literally complied with, it is necessary to examine the purpose, its relationship to other provisions, the terms of the underlying statute, and the consequences of failure to comply with the provision in question.

See also, Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 783 (1984); Caulkins v. Commissioner, 48 T.C.M. 1182 (1984).

The court in Knight-Ridder dealt with a faulty ADR election and found that the purpose of the election regulations was that the election should be binding and that the Commissioner should be put on notice that an election had been made. Knight-Ridder at 795. Because the requirements of the regulations serve this purpose, they were not mere procedural details and went to the essence of regulatory scheme. Id. at 796. The Service, moreover, was prejudiced because it needed to know if an election had been made in order to determine whether an audit was warranted. Id. Accordingly, the plaintiff failed to comply and was not entitled to use the Class Life System for the years in question. Id. at 796-97.

In Caulkins v. Commissioner, 48 T.C.M. 1182 (1984), the question presented for the court's resolution was whether petitioners could use the half-year convention available under ADR. Petitioners had not filed an election to depreciate their computers under ADR, but nonetheless sought to access its provisions. Id. at 1182. Although, the central issue was whether the petitioners could access the ADR regulations, the court looked into the purposes behind the specific depreciation regulation which petitioners sought to access. The court noted that where ADR is elected, "the taxpayer must maintain books and records that contain eight prescribed items of information." Id. at 1184. The court maintained that –

> The filing required is no mere technicality. The regulations are administrative directives promulgated by the Commissioner. Among its basic purposes is the facilitation of the full and fair collection of revenue. When transactions extend over a number of years (as do depreciation accounts) and tax benefits have been conferred in the early year, it is necessary for the Internal Revenue Service to be able to trace the history of these transactions to ensure compliance with the law." Id. at 1185.

Therefore, the petitioner had not substantially complied and was not allowed to claim the benefits of ADR. Id. at 1186. See also, Fuentes v. Commissioner, 85 T.C. 657 (1985); Regan v. Commissioner, 45 T.C.M. 389 (1982). Cases where the taxpayer proved substantial compliance with depreciation regulations have turned on factors such as that the information was in fact available to the Commissioner and there was no prejudice. See Tipps v. Commissioner, 74 T.C. 458 (1980). All these cases indicate, however, that the determination of substantial compliance is a fact intensive investigation.

While we are dealing with several different sections of the regulations, it should be noted that they are interrelated and the basic ADR election requires that an election

to apply the regulations is an election to apply all the regulations. Treas. Reg. § 1.167(a)-11(a)(1). A correct repair allowance calculation depends on the correct maintenance of several different records. As the court in Caulkins pointed out, these regulatory requirements are not mere technicalities. The information required to be kept by the taxpayer is necessary to ensure compliance with the law. Without this information, the Service cannot trace, for instance, which expenditures are for excluded additions, and which are not. The failure to keep good records on these issues results in prejudice to the Service. Taxpayer has not shown substantial compliance with the regulations.

Nonetheless, because of the fact intensive nature of the determination and because the regulations twice inveigh against invalidating elections so long as the taxpayer has substantially complied in good faith, asserting a substantial compliance argument carries with it litigation hazards.

ISSUE 4: Compliance with ICC retirement rules

Nothing in the statute, the regulations or the legislative history of the provisions support the implementation of the ICC rules for retirement. The regulations themselves deal with retirements and do not suggest that resort to other tools to determine a retirement is appropriate. Moreover, the taxpayer is not required to keep its tax and book records consistent. Tech. Adv. Mem. 83-11-001.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

This case needs further factual development as to whether the rebuilding efforts actually resulted in a retirement and the installation of a new unit. On the basis of the facts now known, it would be difficult to establish retirement under the regulations and taking this position in court involves significant litigation hazards.

As to the other regulations it appears that the taxpayer did not comply with their requirements. To the extent the taxpayer's record keeping is insufficient to establish the amounts spent on excluded additions or whether ineligible property has been placed into a vintage account, or vintage accounts have been inappropriately merged, the taxpayer has failed to sustain its burden of proving it is entitled to a deduction.

Nonetheless, the taxpayer asserts that it may still be able to produce the required information. If such is the case, then going forward with an argument that the taxpayer's ADR election is invalid because it has not substantially complied with the regulations involves substantial litigation hazards in as much as the government will not be able to argue that it has been prejudiced. In any event, a substantial compliance argument under these regulations would involve litigation hazards.

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