INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

ISSUES:

(1) Under the facts described below, is the examining agent required to examine all of the taxpayer's expenditures related to track structure because the examining agent

audited and proposed adjustments to some of the taxpayer's expenditures related to track structure?

(2) Under the facts described below, must the examining agent apply the taxpayer's new method of accounting to certain expenditures related to track structure beginning in year a because the examining agent determined that those expenditures do not qualify for the investment tax credit for years a and b?

CONCLUSIONS:

(1) Under the facts described below, the examining agent is not required to examine all of the taxpayer's expenditures related to track structure because the examining agent audited and proposed adjustments to some of the taxpayer's expenditures related to track structure.

(2) Under the facts described below, the examining agent must apply the taxpayer's new method of accounting to certain expenditures related to track structure beginning in year a because the examining agent determined that those expenditures do not qualify for the investment tax credit for years a and b.

FACTS:

The taxpayer is in the railroad business. The taxpayer incurs significant costs to build, improve, and maintain its railroad track structure. Prior to the repeal of § 167(r) of the Internal Revenue Code of 1954, the taxpayer accounted for costs related to its railroad track structure under the RRB method of accounting. Under the RRB method of accounting, the initial cost of the track structure is capitalized and recovered when the assets are retired. The cost of track structure replacements of similar quality are expensed when incurred. The cost of replacements that are an improvement in quality, betterments, are capitalized.

Section 203(c)(1) of the Economic Recovery Tax Act of 1981, 1981-2 C.B. 256, 284, repealed § 167(r) of the 1954 Code. With the repeal of § 167(r), railroad track structure was subject to § 168 of the 1954 Code ("old § 168"). Under old § 168, the taxpayer was required to capitalize the cost of additions, betterments, and all expenditures incurred in creating "RRB

replacement property."[1] Under old § 168, the additions, betterments, and RRB replacement property were treated as five-year property for calculating recovery deductions, although old § 168(f)(3)(A) provided a four year transition rule for RRB replacement property.

Section 201(a) of the Tax Reform Act of 1986 (TRA 1986), 1986-1 C.B. (vol. 1) 1, 38, amended old § 168. Section 168, as amended, does not require the capitalization of RRB replacement property. As a result, the taxpayer applied for and received the consent of the Commissioner to change its method of accounting for RRB replacement property. The taxpayer received consent to apply §§ 162, 263, and 263A to determine the treatment of RRB replacement property for years beginning after 1986.

Under its present method of accounting for expenditures related to track structure, the taxpayer uses the following procedure. First, the taxpayer identifies the work that is needed, such as c work. A Capital Expenditures Budget for Engineering Services is then prepared for the c work that has been identified. Expenditures for the c work must be approved by the taxpayer's management. If approved, work orders are created to track the expenditures of the c work. (Each job in the work order relates to a single ICC property account in the taxpayer's books.) At the end of the year, the total costs for the c work are extracted from the taxpayer's accounts. The taxpayer then classifies the expenditures for the c work as capital or expense based on a prior determination that is followed for all years. This procedure is followed for all the taxpayer's expenditures for track structure controlled by the taxpayer's Engineering Services budget.

Under its present method, the taxpayer deducted as expenses certain expenditures that were capitalized for financial reporting purposes. These expenditures related to:

(1) c;
(2) d;

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[1]Old § 168(f)(3)(B) generally defines the term RRB replacement property as replacement track material installed by a railroad if the replacement is made: (1) pursuant to a scheduled program for replacement; (2) pursuant to observations by maintenance-of-way personnel of specific track material needing replacement; (3) pursuant to the detection by a rail-test car of specific track material needing replacement; or (4) as a result of a casualty where the replacement track material costs exceed $50,000.

(3) e;
(4) f;
(5) g;
(6) h; and
(7) i.

With regard to expenditures related to:

(8) j;
(9) k; and
(10) l,

the taxpayer capitalized them under old § 168 for years a and b, pursuant to transition rules of section 203(b) of TRA 1986, and capitalized them under its present method of accounting for all subsequent years. In addition, the taxpayer claimed the allowance for the investment tax credit for those expenditures for years a and b pursuant to the transition rules of § 49(e), as enacted by section 211(a) of TRA 1986. The expenditures related to j, k, and l were also capitalized for financial reporting purposes.

The examining agent audited the taxpayer's expense treatment of the expenditures related to activities (1) through (7) and proposes to disallow a portion of those deductions. In addition, the examining agent determined that the expenditures related to activities (8) through (10) do not qualify for the investment tax credit for years a and b, but did not otherwise audit the taxpayer's treatment of those expenditures.[2]

LAW AND ANALYSIS:

Section 446(e) provides that a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

Section 1.446-1(a)(4) provides in relevant part that each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. The following are

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[2]We note that the taxpayer had filed an informal claim for refund regarding the expenditures related to activities (8) through (10) and that the examining agent began an audit of that claim. The taxpayer, however, withdrew the informal claim for refund and the audit of the claim ended prior to its conclusion.

among the essential features that must be considered in maintaining such records: (ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

Section 1.446-1(e)(2)(ii)(a) provides that a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in the computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item that does not involve the proper time for the inclusion of the item of income or the taking of a deduction.

Section 203(b)(1) of TRA 1986 provides that the amendments made by section 201 (regarding § 168) shall not apply to –

> (A) any property which is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract which was binding on March 1, 1986,
>
> (B) property which is constructed or reconstructed by the taxpayer if –
>
> > (i) the lesser of (I) $1,000,000, or (II) 5 percent of the cost of such property has been incurred or committed by March 1, 1986, and
> >
> > (ii) the construction or reconstruction of such property began by such date, or
>
> (C) an equipped building or plant facility if construction has commenced as of March 1, 1986, pursuant to a written specific plan and more than one-half of the cost of such

equipped building or facility has been incurred or committed by such date.

Section 203(b)(2)(A) of TRA 1986 provides in relevant part that paragraph (1) shall not apply to any property unless such property has a class life of at least 7 years and is placed in service before the applicable date, which is January 1, 1989 in the case of property with a class life of at least 7 years but less than 20 years.

Section 211(a) of TRA 1986 added § 49 to the 1986 Code. Section 49(e) provided, in relevant part, that the term "transition property" means any property placed in service after December 31, 1985, and to which the amendments made by section 201 of TRA 1986 do not apply, except that in making such determination section 203(b)(1) of such Act shall be applied by substituting "December 31, 1985" for "March 1, 1986."

Revenue Ruling 90-38, 1990-1 C.B. 57, holds that a taxpayer may not, without the Commissioner's consent, retroactively change from an erroneous to a permissible method of accounting by filing amended returns, even if the period for amending the return for the first year in which the erroneous method was used has not expired.

Issue (1):

The taxpayer contends that, because the examining agent audited the taxpayer's treatment of the expenditures related to activities (1) through (7), the examining agent must audit, and adjust as appropriate, all expenditures related to track structure. The taxpayer puts forth two arguments in support of its position.

The taxpayer's first argument is that its track structure maintenance operation constitutes a single "item" for purposes of applying its method of accounting. The taxpayer contends that its "track structure is a single, integrated asset, both in how it is used and how it is maintained. The various components that make up the track structure have no separate utility for the [t]axpayer, other than as part of the track structure. They are installed as one, inspected as one, repaired as one, and used as one. Thus, together they comprise a single asset and the costs of maintaining that single asset constitute a single 'item' for tax accounting purposes." This conclusion, the taxpayer contends, is supported by its request to change its method of accounting for "track structure maintenance expenditures," and the Tax Court's decision in Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497 (1980)(expenditures falling into

four different ICC property accounts treated as a single class of assets).

The taxpayer's second argument is that, even if the cost of maintaining its track structure does not constitute a single tax accounting item, because track structure maintenance is so interrelated, the examining agent can not examine one activity related to track structure without examining all of the activities.

We believe that the relevant inquiry in this case is the taxpayer's accounting for the expenditures at issue. Under the taxpayer's method of accounting for the expenditures, the taxpayer independently determined whether the expenditures related to each activity were required to be capitalized or expensed. We believe that the examining agent properly may determine which, if any, of the taxpayer's determinations will be audited. Thus, we do not view as relevant or determinative the taxpayer's classification of its track structure as a single asset, the costs of maintaining which constitute a single item for tax accounting purposes.[3]

As a general matter, the examining agent, in his discretion, determines the scope of an audit. Although an examining agent may be required to make certain interrelated adjustments in situations where the examining agent has conducted an examination, in the present case the examining agent audited activities (1) through (7) and proposed adjustments with regard to each activity. Therefore, we are not faced with a situation where the examining agent audited a number of interrelated issues and proposed adjustments only for activities that produced positive adjustments. As a result, we are not faced with, and do not address, the question of whether the examining agent would be required to make interrelated adjustments in this case had the examining agent audited activities (8) through (10).

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[3]Furthermore, we do not believe that the ruling consenting to a change in the taxpayer's method of accounting or the Tax Court's opinion in Southern Pacific supports the conclusion that the taxpayer's track structure maintenance operation constitutes a single "item" for purposes of applying its method of accounting. Neither the ruling nor the court's opinion addressed the issue of whether the method consisted of one or more "items." We do note, however, that the court's holding in Southern Pacific is that "a change in the treatment of the expenditures at issue would constitute a change in petitioner's 'method of accounting' for these *items*." Southern Pacific, 75 T.C. at 683 (emphasis added).

Issue (2):

The taxpayer contends that, because the examining agent denied the investment tax credit with regard to the expenditures related to activities (8) through (10) for years a and b, the examining agent must audit, and adjust as appropriate, the treatment of those expenditures.

The taxpayer received consent to change its method of accounting for RRB replacement property beginning in year a. The taxpayer changed its method of accounting for expenditures related to activities (1) through (7) beginning in year a. For expenditures related to activities (8) through (10), the taxpayer treated those expenditures under old § 168 for years a and b, pursuant to the transition rules of section 203(b) of TRA 1986. The taxpayer also claimed the investment tax credit for the expenditures related to activities (8) through (10) for years a and b, under the transition rules of § 49(e). The taxpayer accounted for the expenditures related to activities (8) through (10) under its new method of accounting for year m and subsequent years.

The examining agent determined that the expenditures related to activities (8) through (10) do not qualify for the investment tax credit in years a and b because the expenditures do not meet the transition rules under § 49(e) (for reasons other than the year the property was placed in service). Because of the interrelationship of the transition rules of § 49(e) and 203(b) of TRA 1986, the examining agent determined that the expenditures are not subject to old § 168 for years a and b.

When the taxpayer determined that the expenditures related to activities (8) through (10) were subject to old § 168 for years a and b (erroneously or otherwise), the taxpayer necessarily classified the expenditures as capital for those years because, notwithstanding the fact that the taxpayer received consent to change its method of accounting for RRB replacement property, the taxpayer was required to capitalize any expenditure that was subject to the transition rules under section 203(b) of TRA 1986. It is also the case, however, that any expenditures for RRB replacement property that were not required to be capitalized under old § 168 were to be treated under the taxpayer's new method of accounting.

Therefore, we believe that, in accordance with his finding that the expenditures related to activities (8) through (10) were not subject to old § 168 for years a and b, the examining agent is required to make the adjustments for years a and b, if any,

necessary to conform the treatment of the expenditures consistent with the taxpayer's new method of accounting.

Because the taxpayer contends that it incorrectly classified the expenditures related to activities (8) through (10) in year m and subsequent years and year a is the first year of the taxpayer's new method of accounting, there is a question as to how the examining agent is to conform the treatment of the expenditures to the taxpayer's new method of accounting.

The taxpayer contends that the examining agent should be required to audit and correct the taxpayer's new method when the examining agent conforms the treatment of the expenditures. We do not believe that the examining agent is required to audit the expenditures related to activities (8) through (10) for year a and subsequent years. Rather, we believe that the taxpayer adopted a method of accounting for the expenditures when it used the new method in year m and subsequent years and that the examining agent may conform years a and b with that method without auditing it. If the taxpayer believes that its new method of accounting for the expenditures is incorrect, the taxpayer may apply to change its method of accounting on a prospective basis under § 446(e), § 1.446-1(e)(3), and Rev. Proc. 97-27, 1997-1 C.B. 680.

Finally, the taxpayer contends that its treatment of the expenditures related to activities (8) through (10) in year m and subsequent years was a posting error that the taxpayer may correct by amending its returns. We do not believe that the taxpayer's classification of the expenditures, if erroneous, is in the nature of a posting error. We believe that the taxpayer adopted a method of accounting for the expenditures, which it used for more than two consecutive years. Therefore, to change its method of accounting for the expenditures, the taxpayer must apply to change its method of accounting prospectively. See Rev. Proc. 90-38, 1990-1 C.B. 57.

CAVEAT:

A copy of the Technical Advice Memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.