American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

July 16, 2012

Mr. Andrew Keyso, Jr.
Associate Chief Counsel
(Income Tax & Accounting)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: Comments on Proposed and Temporary Regulations under Sections 162(a), 168, and 263(a) Regarding Deduction and Capitalization of Expenditures Related to Tangible Property (REG-168745-03 and TD 9564) and Revenue Procedures 2012-19 and 2012-20

Dear Mr. Keyso:

The American Institute of CPAs (AICPA) is writing in response to Notice of Proposed Rulemaking (REG-168745-03)[1] and Temporary Regulations (TD 9564),[2] which request comments regarding proposed and temporary regulations under sections 162(a), 168, and 263(a) of the Internal Revenue Code, relating to the deduction and capitalization of expenditures related to tangible property. These comments were developed by the Repair Regulations Task Force of the AICPA's Tax Methods and Periods Technical Resource Panel, and approved by the Tax Executive Committee.

This letter and attached comments cover a variety of key considerations as the Department of the Treasury (Treasury) and Internal Revenue Service (IRS) work on guidance in this area. The AICPA previously submitted initial comments on April 17, 2012,[3] as well as through oral testimony[4] at the public hearing on May 9, 2012. This letter and attached document incorporate those previous comments and suggestions on this subject, expand on some of those prior comments and recommendations, and also

[1] http://www.gpo.gov/fdsys/pkg/FR-2011-12-27/pdf/2011-32246.pdf.
[2] http://www.gpo.gov/fdsys/pkg/FR-2011-12-27/pdf/2011-32024.pdf.
[3]http://www.aicpa.org/InterestAreas/Tax/Resources/TaxMethodsPeriods/Advocacy/DownloadableDocuments/AICPA-04.17.2012-Repairs-Comments.pdf, AICPA comment letter dated April 17, 2012.
[4]http://www.aicpa.org/InterestAreas/Tax/Resources/TaxMethodsPeriods/Advocacy/DownloadableDocuments/AICPA-05.09.2012-tangibles-oral-testimony.pdf, written transcript of AICPA's oral testimony of May 9, 2012.

provide additional comments and recommendations in areas not previously commented on by the AICPA.

The AICPA is the national professional organization of certified public accountants comprised of approximately 377,000 members. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Executive Summary

The AICPA commends Treasury and IRS for their continued efforts to produce administrable capitalization guidance, and for their responsiveness to concerns raised by the AICPA and other commentators throughout the development process. The AICPA appreciates the opportunity to provide comments and work with Treasury and the IRS in developing guidance that is administrable and will reduce future controversy involving tangible property capitalization. In general, the AICPA comments and submits recommendations on the following issues raised by the proposed and temporary regulations and Rev. Procs. 2012-19 and 2012-20 ("Method Change Guidance"):

A. Administrative Burden / Complexity

The AICPA is concerned that the overall approach in the temporary regulations relies too heavily on a "facts and circumstances" based approach and contains too few bright-line tests and safe harbors to alleviate administrative burden and complexity in the capitalization area. Although the AICPA might view a modest increase in administrative burden as an acceptable tradeoff for a simplified set of rules, the AICPA believes that, taken as a whole, the temporary regulations impose additional administrative burdens without eliminating the often controversial aspects of applying general capitalization principles.

B. Illustrative Examples

Because of the interrelationship among the various sections of the temporary regulations, particularly the disposition provisions, the general asset account (GAA) elections, and the improvement provisions, the AICPA believes there should be one or more examples illustrating these interactions to help taxpayers make informed decisions with respect to elections and to enable taxpayers to avoid unintentional missed elections in their efforts to comply with the regulations.

C. Materials and Supplies – Temp. Treas. Reg. § 1.162-3T

The AICPA recommends that the final regulations specifically permit taxpayers to include labor and overhead costs as part of the cost of a material and supply as defined by Temp. Treas. Reg. § 1.162-3T. The AICPA also believes that rather than including the 12-month rule within the definition of a material and supply, the final regulations should retain the 12-month rule included in the 2006 proposed regulations so as to provide greater consistency between the intangible and tangible property capitalization guidance. With respect to rotable and temporary spare parts, the AICPA believes that the default method should be the method most likely to be used by taxpayers rather than a method few, if any, taxpayers use. The AICPA suggests that the final regulations include an example of the recovery of materials and supplies for which a taxpayer has made an election to capitalize. The AICPA also recommends that the final regulations provide a definition of "incidental" materials and supplies. Finally, the AICPA believes the final regulations should clarify that taxpayers may use a cost flow assumption in determining the cost of non-incidental materials and supplies used or consumed during the taxable year.

D. Acquisition Costs – Temp. Treas. Reg. § 1.263(a)-2T

The AICPA recommends that the inherently facilitative rules in the temporary regulations be changed such that only specific activities are considered inherently facilitative and not all activities of a certain type of service provider.

The AICPA believes that if a taxpayer's capitalization threshold is appropriate for financial reporting purposes, then conforming to that threshold for federal income tax purposes would not result in a distortion of the taxpayer's taxable income. Accordingly, the AICPA recommends the ceiling be removed for a taxpayer that has an applicable financial statement (AFS) and meets the other requirements of the temporary regulations. Additionally, the AICPA believes the requirement that a taxpayer have an AFS to use the de minimis rule unfairly discriminates against smaller taxpayers, and recommends an alternative test to allow such taxpayers to use the de minimis rule. Alternatively, the AICPA suggests that the definition of AFS be expanded to include a financial statement that has been reviewed by a certified public accountant.

E. Improvements – Temp. Treas. Reg. § 1.263(a)-3T

The AICPA recommends that the final regulations clarify when the routine maintenance safe harbor is available – specifically that it only applies in the case of an expenditure otherwise required to be capitalized as a restoration because the expenditure is to rebuild a unit of property to a like-new condition after the end of its useful life or is for the replacement of a major component or substantial structural part of a unit of property. The AICPA also recommends that the final regulations allow application of the routine maintenance safe harbor to building systems as defined for purposes of Temp. Treas. Reg. § 1.263(a)-3T. The AICPA also proposes clarifications and additional examples illustrating the routine maintenance safe harbor.

The AICPA believes that the final regulations should clarify certain betterment rules and the examples illustrating such rules. The AICPA also suggests that the restoration rules include a "bright-line" test for determining whether a component is a major component or substantial structural part of a unit of property. Finally, with respect to the capitalization of improvements, the AICPA recommends that the final regulations include an election to capitalize costs that otherwise would not be subject to capitalization under Temp. Treas. Reg. § 1.263(a)-3T.

F. Dispositions / General Asset Accounts

The AICPA recommends that the final regulations provide that a taxpayer may elect to treat the retirement of a structural component of a building as a disposition rather than mandating such treatment. This would eliminate the potential for errors for failing to treat such retirements as dispositions, remove the need for the complicated GAA and qualifying dispositions elections, and still provide taxpayers flexibility in applying the restoration rules. Alternatively, if the construct in the temporary regulations is retained in the final regulations, the AICPA suggests that a GAA election be the default rule for buildings. If the provisions of the temporary regulations are retained in the final regulations, the AICPA recommends that the government provide examples of components of structural components and application of the consistency requirement as it applies to evaluating subsequent expenditures and dispositions.

G. Method Change Guidance – Revenue Procedures 2012-19 and 2012-20

The AICPA recommends that the government clarify the method change rules for the de minimis rule and late GAA elections. The AICPA requests that the government clarify several issues involving the use of statistical sampling, including for example, that statistical sampling methods not specifically described in Rev. Proc. 2011-42 may be used by taxpayers if allowed upon review by IRS Statistical Sampling Coordinators, and that statistical sampling is permitted even if not specifically noted in the Method Change Guidance. Additionally, the AICPA believes that the goal of reduced controversy involving tangible property capitalization issues will be best served if taxpayers are permitted to use an extrapolation method in computing section 481(a) adjustments. Finally, the AICPA recommends that the Method Change Guidance include examples illustrating how the guidance should apply for multiple interrelated changes, as well as examples illustrating the application of statistical sampling, for example, in conjunction with estimating basis in dispositions.

Each of these areas is addressed in detail in the attachment.

* * * * *

We appreciate your consideration of our recommendations, and we welcome further discussion of the comments. If you have any questions, please contact Jane Rohrs, Co-chair, AICPA Repair Regulations Task Force, at (202) 370-2290, or jrohrs@deloitte.com; Natalie Tucker, Co-chair, AICPA Repair Regulations Task Force, at (904) 680-7209, or natalie.tucker@mcgladrey.com; Carol Conjura, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 533-3040, or cconjura@kpmg.com; or Michelle R. Koroghlanian, AICPA Technical Manager, at (202) 434-9268, or mkoroghlanian@aicpa.org.

Sincerely,

Patricia A Thompson

Patricia A. Thompson, CPA
Chair, AICPA Tax Executive Committee

Enclosure

cc: Scott Dinwiddie, Special Counsel to the Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Merrill Feldstein, Senior Counsel, Income Tax and Accounting, Branch 3, Internal Revenue Service
Alan S. Williams, Attorney, Income Tax and Accounting, Branch 3, Internal Revenue Service
Kathleen Reed, Branch Chief, Income Tax and Accounting, Branch 7, Internal Revenue Service
Patrick Clinton, Assistant to the Branch Chief, Income Tax and Accounting, Branch 7, Internal Revenue Service
Alexa Claybon, Attorney-Advisor, Department of the Treasury, Office of Tax Legislative Counsel
Scott Mackay, Taxation Specialist, Department of the Treasury, Office of Tax Legislative Counsel

AMERICAN INSTITUTE OF CPAs

Comments on Proposed and Temporary Regulations under Sections 162(a), 168, and 263(a) Regarding Deduction and Capitalization of Expenditures Related to Tangible Property (REG-168745-03 and TD 9564) and Revenue Procedures 2012-19 and 2012-20

Developed by:
Repair Regulations Task Force

Jane Rohrs, Co-Chair
Natalie Tucker, Co-Chair

David Auclair
Carol Conjura
Cara Hoffman
James Liechty
Robert Love
George Manousos
Edward Meyette
Kristine Mora
Joseph Mudd
Linden Smith
David Strong
Glenn Walberg

Carol Conjura, Tax Methods and Periods Technical Resource Panel, Chair
David Auclair, Tax Methods and Periods Technical Resource Panel, Immediate Past Chair

James McKee, Jr., Tax Executive Committee Liaison to Tax Methods and Periods Technical Resource Panel

Michelle Koroghlanian, AICPA Technical Manager

Approved by:
Tax Methods and Periods Technical Resource Panel
and
Tax Executive Committee

Submitted to:
Department of the Treasury
Internal Revenue Service

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Comments on Proposed and Temporary Regulations under Sections 162(a), 168, and 263(a) Regarding Deduction and Capitalization of Expenditures Related to Tangible Property (REG-168745-03 and TD 9564) and Revenue Procedures 2012-19 and 2012-20

July 16, 2012

Set forth below are the American Institute of CPAs' additional comments on the proposed regulations under sections 162(a), 168, and 263(a) in response to Notice of Proposed Rulemaking by cross-reference to temporary regulations (REG-168745-03 and TD 9564) and Revenue Procedures 2012-19 and 2012-20 ("Method Change Guidance"), pertaining to deduction and capitalization of expenditures related to tangible property. The AICPA submitted its initial comments on this guidance on April 17, 2012.[1] This document incorporates the comments and suggestions from our April 17, 2012 letter on this subject, and provides additional comments and recommendations.

Executive Summary

The AICPA commends the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) for their continued efforts to produce administrable capitalization guidance, and for their responsiveness to concerns raised by the AICPA and other commentators throughout the development process. The AICPA appreciates the opportunity to provide comments and work with Treasury and the IRS in developing guidance that is administrable and will reduce future controversy involving tangible property capitalization. In general, the AICPA comments and submits recommendations on the following issues raised by the proposed and temporary regulations and Method Change Guidance:

A. Administrative Burden / Complexity

The AICPA is concerned that the overall approach in the temporary regulations relies too heavily on a "facts and circumstances" based approach and contains too few bright-line tests and safe harbors to alleviate administrative burden and complexity in the capitalization area. Although the AICPA might view a modest increase in administrative burden as an acceptable tradeoff for a simplified set of rules, the AICPA believes that, taken as a whole, the temporary regulations impose additional administrative burdens without eliminating the often controversial aspects of applying general capitalization principles.

B. Illustrative Examples

Because of the interrelationship among the various sections of the temporary regulations, particularly the disposition provisions, the general asset account (GAA) elections, and the

[1] http://www.aicpa.org/InterestAreas/Tax/Resources/TaxMethodsPeriods/Advocacy/DownloadableDocuments/AICPA-04.17.2012-Repairs-Comments.pdf, AICPA comment letter dated April 17, 2012.

improvement provisions, the AICPA believes there should be one or more examples illustrating these interactions to help taxpayers make informed decisions with respect to elections and to enable taxpayers to avoid unintentional missed elections in their efforts to comply with the regulations.

C. Materials and Supplies – Temp. Treas. Reg. § 1.162-3T

The AICPA recommends that the final regulations specifically permit taxpayers to include labor and overhead costs as part of the cost of a material and supply as defined by Temp. Treas. Reg. § 1.162-3T. The AICPA also believes that rather than including the 12-month rule within the definition of a material and supply, the final regulations should retain the 12-month rule included in the 2006 proposed regulations so as to provide greater consistency between the intangible and tangible property capitalization guidance. With respect to rotable and temporary spare parts, the AICPA believes that the default method should be the method most likely to be used by taxpayers rather than a method few, if any, taxpayers use. The AICPA suggests that the final regulations include an example of the recovery of materials and supplies for which a taxpayer has made an election to capitalize. The AICPA also recommends that the final regulations provide a definition of "incidental" materials and supplies. Finally, the AICPA believes the final regulations should clarify that taxpayers may use a cost flow assumption in determining the cost of non-incidental materials and supplies used or consumed during the taxable year.

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The AICPA recommends that the inherently facilitative rules in the temporary regulations be changed such that only specific activities are considered inherently facilitative and not all activities of a certain type of service provider.

The AICPA believes that if a taxpayer's capitalization threshold is appropriate for financial reporting purposes, then conforming to that threshold for federal income tax purposes would not result in a distortion of the taxpayer's taxable income. Accordingly, the AICPA recommends the ceiling be removed for a taxpayer that has an applicable financial statement (AFS) and meets the other requirements of the temporary regulations. Additionally, the AICPA believes the requirement that a taxpayer have an AFS to use the de minimis rule unfairly discriminates against smaller taxpayers, and recommends an alternative test to allow such taxpayers to use the de minimis rule. Alternatively, the AICPA suggests that the definition of AFS be expanded to include a financial statement that has been reviewed by a certified public accountant.

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The AICPA believes that the final regulations should clarify certain betterment rules and the examples illustrating such rules. The AICPA also suggests that the restoration rules include a "bright-line" test for determining whether a component is a major component or substantial structural part of a unit of property. Finally, with respect to the capitalization of improvements, the AICPA recommends that the final regulations allow a taxpayer to elect to capitalize costs that otherwise would not be subject to capitalization under Temp. Treas. Reg. § 1.263(a)-3T.

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The AICPA recommends that the final regulations provide that a taxpayer may elect to treat the retirement of a structural component of a building as a disposition rather than mandating such treatment. This would eliminate the potential for errors for failing to treat such retirements as dispositions, remove the need for the complicated GAA and qualifying dispositions elections, and still provide taxpayers flexibility in applying the restoration rules. Alternatively, if the construct in the temporary regulations is retained in the final regulations, the AICPA suggests that a GAA election be the default rule for buildings. If the provisions of the temporary regulations are retained in the final regulations, the AICPA recommends that the government provide examples of components of structural components and application of the consistency requirement as it applies to evaluating subsequent expenditures and dispositions.

G. Method Change Guidance – Revenue Procedures 2012-19 and 2012-20

The AICPA recommends that the government clarify the method change rules for the de minimis rule and late GAA elections. The AICPA requests that the government clarify several issues involving the use of statistical sampling, including for example, that statistical sampling methods not specifically described in Rev. Proc. 2011-42 may be used by taxpayers if allowed upon review by IRS Statistical Sampling Coordinators, and that statistical sampling is permitted even if not specifically noted in the Method Change Guidance. Additionally, the AICPA believes that the goal of reduced controversy involving tangible property capitalization issues will be best served if taxpayers are permitted to use an extrapolation method in computing section 481(a) adjustments. Finally, the AICPA recommends that the Method Change Guidance include examples illustrating how the guidance should apply for multiple interrelated changes, as well as examples illustrating the application of statistical sampling, for example, in conjunction with estimating basis in dispositions.

Each of these areas is addressed in detail below.

A. Administrative Burden / Complexity

The AICPA commends Treasury and the IRS for their continued efforts to produce administrable capitalization guidance and for their responsiveness to concerns raised by the AICPA and other commentators throughout the development process. However, the AICPA is concerned that the overall approach in the temporary regulations relies too heavily on a "facts and circumstances" based approach, and contains too few bright-line tests and safe harbors to alleviate administrative burdens and complexity in the capitalization area.

For example, with respect to elections, one way the temporary regulations could ease significant administrative burden and potential traps for the unwary would be to make the GAA election the default rule for buildings such that an affirmative election statement would only be required if the taxpayer does not want to make a GAA election for a building. Because the new operating rules for GAAs permit taxpayers to elect to either continue depreciation or discontinue depreciation and recognize gain or loss for any or all dispositions from such an account, it would appear that taxpayers have little if any incentive to not make a GAA election for a building. This situation is similar to the election under section 195 to amortize start-up costs. In the final regulations under section 195, Treasury converted what had previously been an affirmative election requirement to the default rule based on the understanding that most taxpayers would prefer to amortize start-up expenditures and very few would prefer to have no amortization.

The AICPA believes that certain provisions are well suited to minimize compliance efforts, but that benefit is offset by administrative demands in other provisions of the regulations. In the context of the routine maintenance safe harbor, for example, the AICPA appreciates that Temp. Treas. Reg. § 1.263(a)-3T(g)(4) equates the class life of a unit of property under the alternative depreciation system (ADS) with the testing period for the maintenance activities. As Treasury and the IRS correctly noted in the preamble:

> The class life based standard is more objective, is more consistent among taxpayers, and is more administrable than a standard based on the economic useful life of the property.

But in other instances, the temporary regulations require an inquiry into the economic useful life of property, such as in the definition of materials and supplies under Temp. Treas. Reg. § 1.162-3T(c). The regulations thus adopt an admittedly less administrable standard and contemplate that – for a taxpayer without a useful life established for depreciation purposes on an AFS – an economic useful life would be determined and substantiated where no such record is maintained for book purposes. Although the administrative demands to gather and assess particular information might seem minimal when viewing a capitalization rule in isolation, the AICPA believes that the combined administrative burdens for all of the provisions make compliance with the temporary regulations difficult.

Although the AICPA might view a modest increase in administrative burdens as an acceptable tradeoff for a simplified set of rules, the AICPA believes that, taken as a whole, the temporary regulations impose additional administrative burdens without eliminating the often controversial aspects of applying general capitalization principles. As a result, taxpayers and their advisers face the additional task of complying with a complex set of regulations where the regulations themselves continue to require many of the same controversial facts-and-circumstances based determinations that the guidance was intended to address. For example, the temporary regulations still require a consideration of all the facts and circumstances to identify facilitative transaction costs under Temp. Treas. Reg. § 1.263(a)-2T(f)(2), to determine a unit of property for network assets under Temp. Treas. Reg. § 1.263(a)-3T(e)(3)(iii)(B), to aggregate related amounts for an improvement under Temp. Treas. Reg. § 1.263(a)-3T(f)(4), to qualify for the routine maintenance safe harbor under Temp. Treas. Reg. § 1.263(a)-3T(g)(1), to identify a betterment under Temp. Treas. Reg. § 1.263(a)-3T(h)(3), and to determine whether a replacement comprises a major component or substantial structural part of a unit of property under Temp. Treas. Reg. § 1.263(a)-3T(i)(4). The AICPA believes that, where the temporary regulations merely incorporate the often contentious facts-and-circumstances determinations from case law and prior guidance, the need to make those determinations plus the obligation to comply with all of the other requirements in the temporary regulations is overly burdensome.

The AICPA accordingly is concerned that the temporary regulations impose too many administrative burdens in their entirety. At a minimum, the complex set of rules with many interrelated aspects contained in the nearly two hundred fifty pages that were released on December 23, 2011, and the additional nearly one hundred pages of procedural guidance released in March 2012, will require taxpayers and their advisers to devote significant resources annually in order to understand and apply the rules. Unfortunately, substantial effort is required to apply the nuanced rules to non-abusive, commonplace transactions such as the purchase of a supply item. The AICPA is concerned that the complex nature and administrative burden of the temporary regulations might lead to noncompliance. Therefore, the AICPA strongly encourages Treasury and the IRS to reconsider the general approach of this guidance. The AICPA appreciates the tremendous efforts that have gone into this project so far; however, the AICPA believes that the guidance will not be effective without including a simplified approach to capitalization that minimizes the accompanying compliance demands. Because this guidance will affect nearly every business taxpayer, the AICPA believes a reconsideration of the overall approach is warranted to prevent, as noted in the preamble to the regulations, "[t]he standards for applying section 263(a), as set forth in the regulations" from becoming "difficult to discern and apply in practice" and creating "considerable uncertainty and controversy for taxpayers."

B. Illustrative Examples

The AICPA commends the IRS and Treasury for including numerous examples illustrating the provisions of the temporary regulations. However, the examples included in the temporary regulations address discrete issues, and do not provide a comprehensive illustration of the interaction of the various sections of the regulations. Accordingly, the AICPA recommends that the final regulations include examples that address the potential impact of more than one of the provisions in the temporary regulations. The AICPA proposes the following as illustrative of the types of examples that would be helpful for taxpayers to comply with the temporary regulations:

> <u>*Example 1*</u>*: X is in the business of leasing space in office buildings that it owns. In Year 1, X discovers that a window in one of the office buildings is broken. Assume that the building, including its windows, is a unit of property under § 1.263(a)-3T(e) and the window is not a rotable or temporary spare part under paragraph (c)(2) of this section. X pays for the acquisition and delivery of a new window to replace the broken window. In the same taxable year, the new window is installed. A window is a structural component of a building; as a result, X recognizes a loss on the disposition of the broken window under § 1.168(i)-8T. Because X has recognized a loss on the disposition of the window, X must capitalize the cost of the new window under § 1.263(a)-3T(i)(1)(i).*

> <u>*Example 2*</u>*: Assume the same facts as in Example 1, except that X made a general asset account election under § 1.168(i)-1T for the office building. As a result of the general*

asset account election X does not recognize a loss on the disposition of the window. See § 1.168(i)-1T(e). Because X does not recognize a loss, the window is not an improvement under § 1.263(a)-3T(i)(1)(i). The replacement window also is not a betterment under § 1.263(a)-3T(h), a restoration under §1.263(a)-3T(i), or an adaptation under § 1.263(a)-3T(j). Under § 1.162-3T(a)(1), the amounts X paid for the acquisition and delivery of the window are deductible in the taxable year in which the window is installed in the building.

Finally, the AICPA believes it would be helpful to taxpayers if the examples in the final regulations used similar property to illustrate concepts. For example, in illustrating what is or is not an industrial process for purposes of defining plant property, the temporary regulations use two disparate businesses – industrial linen cleaning operation and local restaurant – rather than industrial linen cleaning operation and local drycleaner or industrial food manufacturer and local restaurant. Use of similar trades or businesses would be of more use to taxpayers in understanding and applying the temporary regulations to their particular facts. Additional examples of industrial processes that are intended to be covered would also be helpful for taxpayers.

C. Materials and Supplies – Temp. Treas. Reg. § 1.162-3T

The temporary regulations generally provide that the costs of incidental materials and supplies are deductible when purchased, and the costs of non-incidental materials and supplies are deducted when used or consumed.[2] Under the temporary regulations, materials and supplies include any item of tangible property consumed in a trade or business that is not inventory and falls into one of the following five categories:

(i) Is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer that is not acquired as part of any single unit of tangible property;
(ii) Consists of fuel, water, and similar items reasonably expected to be consumed within 12 months or less of first use;
(iii) Is a unit of property, but has an economic useful life of 12 months or less from first use;
(iv) Is a unit of property but has an acquisition or production cost of $100 or less; or,
(v) Is identified in published guidance as a material or supply.[3]

1. <u>Clarify Treatment of Labor Costs</u>

The temporary regulations provide taxpayers with the ability to elect to apply the de minimis rule of Temp. Treas. Reg. § 1.263(a)-2T(g) to any material and supply.[4] With respect to deducting amounts under the de minimis rule, the preamble to the temporary regulations specifically states that "the de minimis rule does not apply to amounts paid for labor and overhead incurred in

[2] Temp. Treas. Reg. § 1.162-3T.
[3] Temp. Treas. Reg. § 1.162-3T(c).
[4] Temp. Treas. Reg. § 1.162-3T(f).

repairing or improving property." However, no such limitation applies in the context of materials and supplies. Thus, if a taxpayer elects to treat materials and supplies under the de minimis rule, an issue arises as to whether the election applies to labor and overhead included in materials and supplies. Another issue that arises is whether a taxpayer may include labor and overhead in the cost of a material and supply, or whether it is required to analyze each invoice to exclude labor charges from the cost of a material and supply. The requirement to analyze each individual invoice for an item that meets the definition of a material and supply as set forth above would be an administrative burden for taxpayers. Further, if a taxpayer produced its materials and supplies (e.g., replacement parts), it would seem illogical to require the taxpayer to remove labor and overhead costs that would be required to be capitalized under section 263A. Accordingly, the AICPA recommends that the final regulations specifically allow taxpayers to include labor and overhead costs as part of the cost of a material and supply as defined by Temp. Treas. Reg. § 1.162-3T.

2. <u>12-Month Rule</u>

The inclusion of units of property with a useful life of not more than 12 months in the definition of a material and supply first appeared in the 2008 Proposed Regulations. The 2006 Proposed Regulations had included a separate 12-month rule under which amounts paid for tangible property with a useful life of 12 months or less were not required to be capitalized.[5] The 2006 Proposed Regulations 12-month rule was similar to the one adopted for intangible property under Treas. Reg. § 1.263(a)-4(f). The inclusion of such items in the definition of a material or supply, however, did not eliminate the need or support for a general 12-month rule in this context. Under pre-existing guidance, if tangible property used in a business had an economic useful life of not more than one year, the courts and the IRS had allowed an immediate deduction for such property, and the property did not necessarily have to be accounted for only when used or consumed as in the case of non-incidental materials and supplies.[6] Under the temporary regulations, items with a useful life of not more than 12 months may only be deducted at the time of purchase if they qualify as incidental materials and supplies, or (subject to the ceiling) are taken into account under the de minimis rule. This treatment will create an anomaly between the capitalization rules for tangible and intangible property that did not exist before because prior case law and IRS rulings have recognized the rule in both contexts.

We recommend that the 12-month rule as contained in the 2006 Proposed Regulations[7] be reinstated to create more consistency in the accounting treatment of tangible and intangible property. This treatment is particularly warranted where the time period elapsed between the date of acquisition or production of the short-lived property and the date when the property's use ends is less than 12 months. In that case, the property is not sitting in storage for an extended

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[5] Prop. Treas. Reg. § 1.263(a)-2(d)(4).

[6] See, *e.g., Comm'r v. Van Raden*, 650 F.2d 1046 (9th Cir. 1981) (payment in December of 1972 for cattle feed calculated to meet the needs of the taxpayer for one year was fully deductible in 1972 even though some of the feed was not consumed until 1974); Rev. Rul. 89-62, 1989-1 C.B. 78 (allowing deduction for cost of videocassettes with useful life of one year or less); Rev. Rul. 73-357, 1973-2 C.B. 40 (allowing deduction for cost of tires with an average useful life of less than one year); Rev. Rul. 69-81, 1969-1 C.B. 137 (allowing deduction for cost of clothing, towels, and other items with a useful life of one year or less); but see Rev. Rul. 78-382, 1978-2 C.B. 111 (allowing deduction for cost of rental uniforms, but in year placed in service, because "[m]ost uniforms do not remain in use for 12 months").

[7] See Prop. Treas. Reg. § 1.263(a)-2(d)(4).

period of time and the taxpayer should be permitted to expense the short-lived property as soon as the property is acquired or produced, rather than when the property begins to be used or consumed as a material or supply. Expensing short-lived property upon its acquisition is more akin to a depreciation convention; under the depreciation rules, depreciation commences when property is available for use, rather than when the actual use of the property commences.

3. Rotable / Temporary Spare Parts

The temporary regulations provide taxpayers with three different methods of accounting for rotable and temporary spare parts:

1) Deduct the cost of the rotable or temporary spare part when disposed of by the taxpayer (the default method);[8]
2) Capitalize and depreciate the cost of a rotable or temporary spare part over the applicable recovery period (an elective method);[9] or,
3) The optional method under which a taxpayer may (a) deduct the amount paid for a new rotable spare part in the year in which it is installed in equipment, (b) include in income and assign a cost basis equal to the fair market value of the used, non-functioning part, (c) capitalize the cost of repairing the part, and (d) deduct the basis of the part when re-installed if it is later used as a replacement part (an elective method).[10]

The AICPA commends Treasury and the IRS for providing the optional method of accounting for rotable and temporary spare parts, but believes that the default method should be the method most likely to be used by taxpayers rather than a method few, if any, taxpayers use. Thus, the AICPA recommends that the final regulations provide that the default method is the optional method (which is the default method for generally accepted accounting principles (GAAP)), with the ability to capitalize and depreciate the cost of a rotable or temporary spare part over the applicable recovery period or to deduct the cost of the rotable or temporary spare part when disposed of by the taxpayer as elective methods. In addition, the AICPA recommends that the final regulations provide a safe harbor under the optional method that the fair market value of the used, non-functioning part may equal the value assigned to the part in the taxpayer's financial statements.

4. Methods to Identify Non-Incidental Materials and Supplies

The AICPA understands that Temp. Treas. Reg. § 1.162-3T may be interpreted in a manner that is not practically administrable. In particular, the AICPA understands that this section may be interpreted to require the use of a specific identification method to determine the cost of non-incidental materials and supplies that have been used and consumed in a taxpayer's operations as compared to the cost of the non-incidental materials and supplies that remain on hand. The specific language of Temp. Treas. Reg. § 1.162-3T(a)(1) provides:

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[8] Temp. Treas. Reg. § 1.162-3T(a).
[9] Temp. Treas. Reg. § 1.162-3T(d).
[10] Temp. Treas. Reg. § 1.162-3T(e).

> *Non-incidental materials and supplies*. Amounts paid to acquire or produce materials and supplies are deductible in the taxable year in which the materials and supplies are used or consumed in the taxpayer's operations.

The temporary regulations are silent as to how a taxpayer is to determine the cost of the non-incidental materials and supplies that are used and consumed in its operations. That is, the temporary regulations do not explicitly require that the actual cost of the non-incidental materials and supplies consumed and used in operations be determined using a specific identification method. In fact, the temporary regulations do not provide any guidance as to how a taxpayer should identify the cost of the non-incidental materials and supplies to be deducted when such materials and supplies are used in its operations. Taking into account the fact that many taxpayers use hundreds, if not thousands, of different fungible materials and supplies in their operations, it would be reasonable to assume that the use of a cost flow assumption would be permitted. Specifically, given the impracticability of the use of a specific identification method when the subject materials and supplies consist of thousands of small fungible items (i.e., where it is impossible to determine the specific materials and supplies that have been used), a cost flow assumption such as a first-in, first-out (FIFO), last-in, first out (LIFO), or an average cost method should be allowable provided the method clearly reflects the taxpayer's taxable income.

It is important to recognize that tracking the costs of non-incidental materials and supplies is often similar to tracking the cost of inventory. Thus, the use of inventory cost flow assumptions should also be permitted for non-incidental materials and supplies. For example, the temporary regulations appear to recognize that "inventory" methods are used for material and supplies when stating "[a]mounts paid to acquire or produce incidental materials and supplies that are carried on hand and for which no record of consumption is kept or of which physical inventories at the beginning and end of the taxable year are not taken, are deductible in the taxable year in which these amounts are paid, provided taxable income is clearly reflected."[11] In addition, materials and supplies may constitute inventoriable costs under section 263A provided they are consumed in a taxpayer's production or resale activities.

Similar to inventory held for sale, the nature of non-incidental materials and supplies often necessitates simplifying conventions to determine the appropriate charge for a period. As with inventory, it is often impossible to individually track each material and supply item that is purchased and then used and consumed in a taxpayer's business. Moreover, it seems inconsistent to allow conventions for tracking inventory under section 471 but not to allow similar conventions for non-incidental materials and supplies, particularly considering the fact that such materials and supplies usually are less material to a taxpayer's income when compared to a taxpayer's section 471 inventory. Thus, the AICPA believes it is reasonable to permit taxpayers to use similar conventions that the government, taxpayers, and practitioners have accepted as necessary to account for the costs of numerous fungible items, whether inventoried under section 471 or treated as non-incidental materials and supplies under Temp. Treas. Reg. § 1.162-3T.

[11] Temp. Treas. Reg. § 1.162-3T(a)(2).

The IRS and the courts have previously recognized the need for conventions to account for materials and supplies.[12] For example, in *Madison Gas,* the Tax Court reviewed the taxpayer's method of accounting for the cost of coal, a material and supply, consumed in generating electric power. Given the fungible nature of coal, the Tax Court found that "accounting for the cost of each piece of coal actually used by petitioner on a ton-by-ton basis would be **impractical**."[13] (Emphasis added.) Moreover, the IRS must have recognized the impracticability of the use of a specific identification method given the taxpayer's facts, as it did not argue for the use of a specific identification method to account for the coal. Rather, the IRS merely argued for the use of a cost flow method that was different from the LIFO cost flow method employed by the taxpayer.

In *Madison Gas*, the taxpayer essentially used a LIFO cost flow assumption to account for the cost of its coal for both financial statement and tax purposes. In contrast, the IRS in *Madison Gas* argued for the use of a FIFO cost flow assumption to account for the cost of the taxpayer's coal. The Tax Court in *Madison Gas* found that the physical flow of the coal was close to a LIFO flow in that the coal that was delivered during the day was generally used that same day and any unused coal was added to a reserve pile, with the most recently purchased coal in the front of the pile. Accordingly, the cost of coal consumed each month was generally equal to the average cost of the coal purchased that month plus or minus any coal used or added to the reserve piles. As such, according to the Tax Court, the taxpayer's method of accounting for the amount of coal consumed closely followed the physical flow of the coal consumption. Based on these facts, the Tax Court held that the taxpayer's method of accounting for the cost of its coal clearly reflected income.

Similar to *Madison Gas*, it is impractical for many taxpayers to specifically identify the precise materials and supplies that are used during their operations. Non-incidental materials and supplies used by taxpayers include thousands of fungible goods that are not realistically traceable. In fact, in many instances it may be impossible to specifically account for each item. Therefore, a cost flow assumption <u>must</u> be used to account for some non-incidental materials and supplies consumed during the year. As held in *Madison Gas,* the regulations under section 162 should permit the use of a cost flow assumption to account for non-incidental materials and supplies, provided such cost flow assumption clearly reflects income.

The Tax Court's holding in *Madison Gas* is consistent with Treas. Reg. § 1.446-1(a)(2), which provides that a method of accounting that reflects the consistent application of generally accepted accounting principles in a trade or business will ordinarily be regarded as clearly reflecting income. Many taxpayers employ cost flow assumptions for materials and supplies for financial statement purposes.

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[12] See *Madison Gas and Electric Company v. Commissioner*, 72 T.C. 521 (1979) (discussed in this letter). See also Rev. Proc. 2001-10, 2001-1 C.B. 272 (where the IRS allowed small taxpayers with average annual gross receipts of $1,000,000 or less to use the cash method of accounting for non-incidental materials and supplies), Rev. Proc. 2002-28, 2002-1 C.B. 815 (discussed in this letter), and PLR 9209007 (Feb. 28, 1992) (where the taxpayer was permitted to use the average amount of supplies on hand to estimate the total amount of supplies used under Treas. Reg. § 1.162-3).

[13] 72 T.C. at 555.

Further, the IRS has previously permitted the use of an average cost method to account for non-incidental materials and supplies under Treas. Reg. § 1.162-3. More specifically, Rev. Proc. 2002-28 permits the use of an average cost method to account for the cost of a qualifying taxpayer's non-incidental materials and supplies. For purposes of Rev. Proc. 2002-28, a qualifying taxpayer generally includes a taxpayer in certain qualifying industries that has average annual gross receipts equal to or less than $10 million. Presumably, the IRS permitted the use of an average cost method in that instance because it believed that the use of an average cost method would clearly reflect the taxpayer's income.

Further in publishing Rev. Proc. 2008-43,[14] the IRS and Treasury allowed for the use of a rolling-average method for tax purposes, deeming such method as clearly reflecting income under certain circumstances. The revenue procedure relates to inventories under section 471 where a taxpayer already uses a rolling-average cost method for financial accounting purposes. It allows for the use of the financial statement rolling-average method provided the taxpayer re-computes the rolling-average cost of an inventory item either (i) each time the taxpayer purchases or produces an additional unit or units of that item, or (ii) on a regular basis, but no less frequently than once per month.[15]

The IRS did not intend for the safe harbor provided by the revenue procedure to apply if inventory is held for several years or costs fluctuate substantially. Thus, the revenue procedure also provides that the taxpayer's variance percentage may not exceed one percent <u>or</u> the entire inventory of the taxpayer must turn at least four times per year.[16] A taxpayer's variance percentage is determined by (1) subtracting the cost of the ending inventory of the trade or business computed using the taxpayer's rolling-average method from the cost of the ending inventory of the trade or business computed using either the FIFO method or the specific identification method to determine the variance; and then (2) dividing the variance by the aggregate rolling-average cost of the inventory.[17]

Although Rev. Proc. 2008-43 only applies to inventory under section 471 and not to non-incidental materials and supplies, the AICPA believes that it is appropriate to apply this same concept to materials and supplies for the reasons discussed above, including the impracticability of tracking individual material and supply items. Further, the IRS has historically allowed inventory cost flow assumptions (e.g., in *Madison Gas* and Rev. Proc. 2002-28) when analyzing the appropriate treatment of non-incidental materials and supplies.

Moreover, the same issues that prompted the IRS to issue Rev. Proc. 2008-43 – the increasing prevalence of accounting systems such as SAP to use a rolling-average cost – are equally relevant in the context of materials and supplies under Temp. Treas. Reg. § 1.162-3T. That is, many accounting systems today (including SAP) account for both section 471 inventory and materials and supplies under Temp. Treas. Reg. § 1.162-3T using a rolling-average cost method. When a taxpayer's accounting systems account for materials and supplies using a rolling-average cost method, it is impractical for the IRS to enforce an alternative method that the taxpayer is

[14] 2008-2 C.B. 186.
[15] Section 4.01(1) of Rev. Proc. 2008-43.
[16] Section 4.01(2) of Rev. Proc. 2008-43.
[17] Section 4.02 of Rev. Proc. 2008-43.

incapable of using, particularly where the materials and supplies and/or the difference between a specific identification and rolling-average cost method is insignificant.

Currently, a taxpayer using a cost flow assumption to account for its non-incidental materials and supplies may have concerns that its method of accounting will be challenged in exam or a method change request to use such cost flow assumption may be denied. As such, the AICPA recommends that the final regulations under section 162 permit the use of reasonable cost flow assumptions that clearly reflect income for taxpayers accounting for non-incidental materials and supplies.

5. <u>Cost Recovery of Capitalized Materials and Supplies</u>

The AICPA commends the government for providing flexibility in permitting taxpayers to elect to capitalize the costs of materials and supplies. However, the AICPA believes the final regulations should provide examples of how the capitalized costs are to be recovered. For example, because materials and supplies are treated as placed in service when purchased under the temporary regulations, and because materials and supplies are typically consumed and are effectively disposed of through consumption, it is unclear whether a taxpayer is considered to have disposed of the unrecovered capitalized costs in the year the materials and supplies are actually consumed or should continue to recover the capitalized costs even after the materials and supplies have been consumed. This issue may be illustrated in the case of jet fuel. Assume jet fuel meets the definition of a material and supply and is purchased in Year 1. The taxpayer elects to capitalize the jet fuel and recover the capitalized costs through depreciation. In Year 2, the taxpayer uses all of the jet fuel it purchased in Year 1. It is unclear whether the taxpayer's use of the jet fuel constitutes a disposition of the jet fuel in Year 2.

D. Acquisition Costs – Temp. Treas. Reg. § 1.263(a)-2T

1. <u>Transaction Costs</u>

The rules under Temp. Treas. Reg. § 1.263(a)-2T(f) address transaction costs associated with tangible property, and provide that a taxpayer must capitalize amounts paid to facilitate the acquisition or production of real or personal property. In many respects, the rules under the temporary regulations with respect to costs that facilitate the acquisition of real property are similar to the rules for amounts that facilitate certain acquisitive transactions (Covered Transactions) under Treas. Reg. § 1.263(a)-5. There are, however, significant differences in the rules that the AICPA believes highlight the need for certain changes to the temporary regulations.

The general definition of an amount paid to facilitate the acquisition of real and personal property under the temporary regulations is substantially the same as the general definition of an amount paid to facilitate a transaction under Treas. Reg. § 1.263(a)-5 in that both apply to an amount that "is paid in the process of investigating or otherwise pursuing"[18] the transaction. The

[18] Compare Temp. Treas. Reg. § 1.263(a)-2T(f)(2) with Treas. Reg. § 1.263(a)-5(b)(1).

temporary regulations provide an exception to the general rule for acquisitions of real property.[19] Under this rule, an amount paid by the taxpayer in the process of investigating or otherwise pursing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining "whether" to acquire real property and "which" real property to acquire (Whether and Which Test) unless the amount is "inherently facilitative." Similarly, the rules under Treas. Reg. § 1.263(a)-5 provide that an amount paid by the taxpayer in the process of investigating or otherwise pursuing a Covered Transaction does not facilitate the transaction if the amount relates to activities performed prior to the "Bright-Line Date"[20] unless the amount is "inherently facilitative."

The temporary regulations provide an exception to the Whether and Which Test rule by defining certain amounts as being inherently facilitative, meaning that the amounts must be capitalized regardless of the application of the Whether and Which Test. Similarly, Treas. Reg. § 1.263(a)-5 provides an exception to the Bright-Line Date rule by defining certain amounts as being inherently facilitative, meaning that the amounts must be capitalized regardless of the application of the Bright-Line Date rule. However, the exceptions have a significant difference. All of the amounts under the inherently facilitative exception in Treas. Reg. § 1.263(a)-5 relate to activities that directly facilitate a transaction. Not all of the amounts under the inherently facilitative exception in the temporary regulations relate to specific activities that directly facilitate the acquisition of real property. In fact, as currently written, the inherently facilitative rules will result in the capitalization of amounts that do not directly facilitate the acquisition of real property. As discussed below, the AICPA recommends that these rules be changed when the temporary regulations are finalized.

An amount is inherently facilitative of a Covered Transaction under Treas. Reg. § 1.263(a)-5 if it is paid for one of the following:

(1) Securing an appraisal, formal written evaluation, or fairness opinion related to the transaction;
(2) Structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction (e.g., obtaining tax advice on the application of section 368);
(3) Preparing and reviewing the documents that effectuate the transaction (e.g., a merger agreement or purchase agreement);
(4) Obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings;
(5) Obtaining shareholder approval of the transaction (e.g., proxy costs, solicitation costs, and costs to promote the transaction to shareholders); or,

[19] See Temp. Treas. Reg. § 1.263(a)-2T(f)(2)(iii).

[20] Under Treas. Reg. § 1.263(a)-5(e)(1), an amount that is not inherently facilitative is not capitalized under section 263 if that amount relates to activities performed prior to the *earlier* of: (i) the date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or (ii) the date on which the taxpayer's directors (or other governing officials) authorize or approve the material terms of the transaction which have been tentatively agreed to by representatives of the acquirer and the target. This Bright-Line Date test replaced the "whether" and "which" test in Rev. Rul. 99-23, 1999-1 C.B. 998.

(6) Conveying property between the parties to the transaction (e.g., transfer taxes and title registration costs).[21]

All of the above categories relate to specific activities that could be performed by a service provider and are not based on the classification of any one type of service provider. Further, none of the above categories includes all activities performed by a type of service provider. More importantly, all of the above categories relate to activities that directly facilitate a Covered Transaction.

An amount is inherently facilitative of acquiring real property under the temporary regulations if it is paid for one of the following:

(A) Transporting the property (e.g., shipping fees and moving costs);
(B) Securing an appraisal or determining the value or price of property;
(C) Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;
(D) Application fees, bidding costs, or similar expenses;
(E) Preparing and reviewing the documents that effectuate the acquisition of the property (e.g., preparing the bid, offer, sales contract, or purchase agreement);
(F) Examining and evaluating the title of the property;
(G) Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;
(H) Conveying property between the parties, including sales and transfer taxes, and title registration costs;
(I) Finders' fees or brokers' commissions, including amounts paid that are contingent on the successful closing of the acquisition;
(J) Architectural, geological, engineering, environmental, or inspection services pertaining to particular properties; or,
(K) Services provided by a qualified intermediary or other facilitator of an exchange under section 1031.[22]

Unlike the inherently facilitative costs in Treas. Reg. § 1.263(a)-5, the above amounts in the temporary regulations do not relate solely to specific activities performed by service providers, but include all amounts paid to certain types of service providers regardless of activity performed. Specifically, the rules in Temp. Treas. Reg. § 1.263(a)-2T(f)(2)(ii)(I), (J) and (K) above apply to all payments to a type of service provider. Because these rules apply to all payments to a service provider, these amounts are required to be capitalized even if the activities did not directly facilitate a transaction. This overly broad reach of the exception is illustrated by the following example in the temporary regulations:

> *Example 1: Broker's fees to facilitate an acquisition.* X decides to purchase a building in which to relocate its offices and hires a real estate broker to find a suitable building. X pays fees to the broker to find property for X to acquire. Under paragraph (f)(2)(ii)(I) of

[21] See Treas. Reg. § 1.263(a)-5(e)(2).
[22] See Temp. Treas. Reg. § 1.263(a)-2T(f)(2)(ii).

> this section, X must capitalize the amounts paid to the broker because these costs are inherently facilitative of the acquisition of real property.[23]

In a situation where a taxpayer hires a real estate broker to find suitable property, as in the above example, a significant portion of the activities performed by the broker occur before the Whether and Which Test date. Further, these activities do not directly facilitate the acquisition of real property because most, if not all, of the activity during this period relates to property that is never acquired by the taxpayer. For example, the broker will provide information to the taxpayer about a number of properties, only one or none of which may be acquired by the taxpayer. Because the inherently facilitative rules in the temporary regulations require all activities performed by a broker to be classified as inherently facilitative, instead of specific activities, then activities that do not directly facilitate the acquisition are required to be capitalized. There is nothing inherent in all activities performed by brokers that require capitalization of all broker fees. In fact, under normal circumstances, a broker will render significant services that do not facilitate the acquisition of a specific piece of real property because the services are rendered before a taxpayer decides whether and which piece of real property to acquire. It is not logical to classify amounts as being inherently facilitative when the amounts do not directly facilitate the acquisition of real property. This illogical result is caused by the overly broad rules in the temporary regulations which classify amounts as being inherently facilitative based solely on the type of service provider, rather than solely on the specific activity performed.

In contrast to the above example, Treas. Reg. § 1.263(a)-5 contains an example illustrating a fee paid to an investment banker relating to a Covered Transaction.[24] Because not all activities of an investment banker are inherently facilitative under the rules in Treas. Reg. § 1.263(a)-5, the example concludes that the only portions of the investment banker fees that are required to be capitalized as facilitative costs are the portions that relate to specific inherently facilitative activities or to activities performed on or after the Bright-Line Date. Similar to broker fees, there is nothing inherently facilitative in all of the activities performed by an investment banker, and therefore the result in the example is logical since only amounts that directly facilitate the transaction are required to be capitalized.

The AICPA recommends that the inherently facilitative rules in the temporary regulations be changed such that only specific activities are considered inherently facilitative, rather than all the activities of a certain type of service provider. Specifically, the rules in Temp. Treas. Reg. § 1.263(a)-2T(f)(2)(ii)(I), (J) and (K) should be modified to include only specific activities that directly facilitate the acquisition of real property, or that portion of the inherently facilitative cost rules should be removed in the final regulations. If the inherently facilitative cost rules are modified such that only specific activities are considered inherently facilitative, then there will be situations where the fee of a service provider will need to be allocated to activities that are: (1) not inherently facilitative and occur prior to the Whether and Which Test date; and (2) relate to specific inherently facilitative activities or activities that occur on or after the Whether and Which Test date. Such an allocation would be consistent with other rules in the temporary regulations. These rules provide that in situations where personal and real property are acquired in a single transaction, a taxpayer must use a "reasonable allocation" to determine which costs

[23] Temp. Treas. Reg. § 1.263(a)-2T(f)(4), Example 1.
[24] Treas. Reg. § 1.263(a)-5(l), Example 3.

facilitate the acquisition of personal property and which costs relate to the acquisition of real property.[25] The AICPA recommends these rules be expanded to include that a taxpayer must also use a reasonable allocation to determine which costs relate to: (1) activities that are not inherently facilitative and occur prior to the Whether and Which Test date; and (2) activities that are inherently facilitative and occur on or after the Whether and Which Test date.

2. De Minimis Rule

a. Administrability of the De Minimis Rule

The AICPA believes a de minimis rule is essential in any capitalization guidance aimed at reducing controversy. However, the AICPA is concerned that the de minimis rule included in the temporary regulations, and particularly the ceiling on the deductible amount, does not take into account how taxpayers account for items expensed under a book minimum capitalization threshold policy. Specifically, taxpayers generally do not have a single account through which amounts expensed under a capitalization policy are tracked, nor do taxpayers maintain records of the items expensed under such policy. To require taxpayers to capitalize amounts for which they maintain no detailed records, based on an arbitrary ceiling amount that is determined as of the end of the tax year in which the expenditures are made, is simply unadministrable for taxpayers.

A company establishes a minimum capitalization threshold policy to obviate the need to track small dollar expenditures. The de minimis rule ceiling test, computed after the end of the tax year, effectively requires taxpayers to maintain the exact type of information a minimum capitalization threshold is intended to eliminate. The AICPA believes that the inclusion of the ceiling in the final regulations will increase audit controversy and create uncertainty and additional recordkeeping requirements for taxpayers. The AICPA believes that if a taxpayer's capitalization threshold is appropriate for financial reporting purposes, then conforming to that threshold for federal income tax purposes does not result in a distortion of the taxpayer's taxable income.

In addition to the concerns raised above, the presence of a ceiling in the regulations may result in the unequal treatment of similarly situated taxpayers. Specifically, the preamble states that the intent of the IRS and Treasury is to allow taxpayers to deduct amounts in excess of the ceiling if the result clearly reflects income or is the subject of a prior agreement with the taxpayer's examination team. The AICPA believes there is no policy justification to treat taxpayers who do not have a written agreement with an examination team less favorably than those taxpayers who have a written agreement. Accordingly, the AICPA recommends the ceiling be removed.

If the ceiling is retained in the final regulations, the AICPA recommends that taxpayers be permitted to use the sampling procedures provided under Rev. Proc. 2011-42[26] to determine whether the ceiling has been exceeded. Additionally, if the final regulations include a ceiling, the AICPA recommends that the default treatment for any amounts exceeding the ceiling be capitalization, rather than requiring the taxpayer to affirmatively elect capitalization. This eliminates the so-called "cliff effect" under the present language. This would also eliminate

[25] Temp. Treas. Reg. § 1.263(a)-2T(f)(2)(iii)(B).
[26] 2011-2 C.B. 318.

potential controversy if on examination it is determined the capitalization threshold deduction for AFS purposes exceeded the ceiling limitation.

Additionally, if the final regulations include a ceiling, consideration might be given to converting the ceiling into a limitation on the amount of the taxpayer's cost threshold, rather than an annual deduction amount that is difficult to calculate. For example, a taxpayer with $X of gross receipts or assets might be permitted to have a cost threshold of $10,000 per acquisition, whereas a taxpayer with $0.5X of gross receipts or assets might be permitted to have a cost threshold of $5,000 per acquisition, etc. Under this approach, a taxpayer could easily translate its cost threshold into the amount required to stay within the ceiling. In contrast, under the ceiling provided in the temporary regulations, a taxpayer is unable to determine what type of modification to their cost threshold would be necessary to remain within the annual deduction ceiling.

Alternatively, if the final regulations retain the ceiling construct provided in the temporary regulations, the AICPA believes Treasury and the IRS should consider increasing the ceiling amounts to more clearly reflect taxpayers' present AFS minimum capitalization threshold amounts. Additionally, the AICPA believes that similar to the provision in Temp. Reg. § 1.162-3T(c)(1)(iv), the ceiling amounts should be subject to revision through published guidance in the Federal Register or in the Internal Revenue Bulletin.

b. AFS Issues

1. Permit de minimis rule for taxpayers without an AFS / Expand AFS definition

In its comments submitted for the 2008 proposed regulations, the AICPA recommended that eligibility to use the de minimis rule not be predicated on the existence of an AFS.[27] The AICPA believes such a requirement unfairly discriminates against smaller taxpayers, as smaller taxpayers are less likely to have a financial statement that meets the definition of an AFS. The AICPA believes that all taxpayers, not just those with an AFS, should be eligible for the de minimis rule. For taxpayers without an AFS, the AICPA proposed a modified version of what was the safe harbor in the 2008 proposed regulations. Specifically, the AICPA recommended that for taxpayers without an AFS, the de minimis capitalization threshold would be deemed to not distort taxable income if the amount deducted was less than or equal to 0.1 percent of the taxpayer's average annual gross receipts reported on its federal income tax returns for the three taxable years immediately prior to the current taxable year (or, if shorter, the taxable years during which such taxpayer was in existence), with operative rules similar to those under sections 448 and 460.

The AICPA believes that its prior proposal for taxpayers without an AFS is equally applicable under the de minimis rule included in the temporary regulations, and can be applied as a ceiling amount (if the ceiling is retained). Specifically, the AICPA recommends that the de minimis rule be permitted for a taxpayer without an AFS where the taxpayer satisfies the requirement of

[27] http://www.aicpa.org/InterestAreas/Tax/Resources/TaxMethodsPeriods/Advocacy/DownloadableDocuments/AICPA_02_22_2011_tangibles_comments.pdf, AICPA comment letter dated February 22, 2011.

having a written capitalization policy as of the first day of the taxable year that is used for book accounting purposes, follows such capitalization policy for book accounting purposes, and the amount expensed under such written policy does not exceed 0.1 percent of the taxpayer's tax gross receipts as determined under rules similar to those provided in sections 448 and 460. The AICPA believes this approach is fairer to small taxpayers and addresses the concerns of the government.

Alternatively, if the government does not agree with this approach, the AICPA recommends that the definition of an AFS as set forth in the temporary regulations be expanded to include a financial statement that has been reviewed by an independent certified public accountant (CPA) (or in the case of a foreign entity, by a similarly qualified independent professional). In a review engagement, the CPA obtains limited assurance that there are no material modifications that should be made to the financial statements in order for the financial statements to be in conformity with the applicable financial reporting framework. In the United States (U.S.), a review is performed in accordance with Statements on Standards for Accounting and Review Services, issued by the AICPA, and the reviewed financial statements are required to be accompanied by the report of a CPA.[28] Reviewed financial statements are often used by privately-held companies for credit purposes or outside investors when an audit is not required, and provide the user with comfort that the financial statements are in conformity with the applicable financial reporting framework. Thus, the AICPA believes that a capitalization policy used in a reviewed financial statement should provide an appropriate level of comfort to the government that there is not a material distortion of income as a result of the use of such capitalization policy.

2. Clarify AFS application

Under Temp. Treas. Reg. § 1.263(a)-2T(g)(7), if a taxpayer is a member of a consolidated group for federal income tax purposes, and its financial results are reported on the AFS for the consolidated group, then the written accounting procedures provided for the group and utilized for the group's AFS may be treated as the written accounting procedures of the member. An AFS may include entities that are not members of a consolidated group for federal income tax purposes (e.g., partnerships, controlled foreign corporations, etc.). Additionally, many entities subject to U.S. federal income tax may be part of a financial accounting consolidated group with a foreign parent. In such cases, the foreign parent may have an AFS that includes the financial results of the entities subject to U.S. federal income tax even though the foreign parent may have no U.S. federal income tax filing requirement. The AICPA believes that the rules for consolidated groups should be applied based on whether the entity is part of the financial accounting consolidated group rather than the consolidated group for U.S. federal income tax purposes. To illustrate this recommendation, the AICPA proposes the following examples be included in the final regulations:

> _Example 1._ X, a U.S. partnership, is owned 90 percent by A, a member of the D U.S. federal income tax consolidated group. For financial accounting purposes, X's financial results are included in the consolidated financial statements D files with the

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[28] Statements on Standards for Accounting and Review Services applicable to review engagements are codified in the AICPA Professional Standards as AR section 90 and are available at http://www.aicpa.org/Research/Standards/CompilationReview/DownloadableDocuments/AR-00090.pdf.

Securities and Exchange Commission (SEC). Each member of the D financial accounting consolidated group has a separate written capitalization policy that includes a minimum capitalization threshold, and that is followed in the financial results reported on D's consolidated financial statements filed with the SEC. For purposes of this paragraph (g)(7), X has an AFS and a written capitalization policy.

Example 2. Y is a U.S. corporation and parent of a consolidated group of corporations that includes F, a controlled foreign corporation. Y files audited financial statements with the SEC that include the financial results of F. Each member of the Y financial accounting consolidated group has a written capitalization policy that meets the requirements of paragraph (1)(ii) of this section and is reflected in the financial results reported to the SEC. For purposes of this paragraph (g)(7), F has an AFS and a written capitalization policy.

Example 3. C is a U.S. corporation that is a member of the financial accounting consolidated group, whose parent P is a foreign entity. C's financial results are included in the consolidated financial accounting statements P files with the foreign exchange upon which P's interests are traded. C does not have separate audited financial statements. C has a written capitalization policy that meets the requirements of paragraph (1)(ii) of this section and is reflected in the financial results reported in P's AFS. For purposes of this paragraph (g)(7), C has an AFS and a written capitalization policy.

3. Definition of tax gross receipts

The temporary regulations provide a ceiling on the amount that may be deducted under the de minimis rule. Such ceiling is equal to the greater of – (1) 0.1 percent of the taxpayer's gross receipts for the taxable year as determined for federal income tax purposes, or (2) 2 percent of the taxpayer's total depreciation and amortization expense for the taxable year as determined in its AFS.[29] If the ceiling amount is retained in the final regulations, the AICPA suggests that the final regulations include a definition of "gross receipts" for purposes of applying the ceiling. Specifically, the AICPA recommends the final regulations provide that "gross receipts" for such purpose be determined in accordance with Temp. Treas. Reg. § 1.448-1T(f)(2)(iv)(A) or Treas. Reg. § 1.263A-3(b).

E. Improvements – Temp. Treas. Reg. § 1.263(a)-3T

1. Coordination with Section 263A

The temporary regulations provide (as did the 2008 Proposed Regulations) that, if expenditures do not result in a betterment, restoration, or new use under the temporary regulations, they are not required to be capitalized under the so-called "plan of rehabilitation" doctrine that had previously been applied by various courts and the IRS.[30] Instead, the temporary regulations note

[29] Temp. Treas. Reg. § 1.263(a)-2T(g)(1)(iv).
[30] Temp. Treas. Reg. § 1.263(a)-3T(f)(3).

that section 263A already contains a standard for determining whether otherwise deductible repair expenses are required to be capitalized with respect to an improvement activity, and should therefore take precedence over any prior law doctrine. Under section 263A, the cost of otherwise deductible repairs is required to be capitalized if the repair activity directly benefits or is incurred by reason of the performance of a production activity (i.e., the capital improvement activity).[31] The AICPA agrees that the incorporation of a single standard in the regulations will prevent inconsistencies in the application of the plan of rehabilitation doctrine that often arose under prior law.

Temporary Treas. Reg. § 1.263(a)-3T(h)(4), *Example 8*, is intended to illustrate the application of this rule in the context of costs incurred during an improvement of property with respect to the remodel of a retail facility. Under the facts of the example, certain expenditures relating to a building refresh, which were currently deductible when incurred in isolation, were required to be capitalized because the example assumed the costs directly benefitted or were incurred by reason of the improvement activity.[32] The specific refresh activities performed on the building and for which the costs were held to be currently deductible when standing alone included: making lighting relocations and flooring repairs to correspond with the reconfiguration of display tables and racks, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing vinyl flooring throughout the store building, and power washing building exteriors. However, when these same activities were performed at the same time as a substantial remodel that included removing and rebuilding walls to move built-in changing rooms and specialty departments to different areas of the stores, replacing ceilings with acoustical tiles to reduce noise and create a more pleasant shopping environment, rebuilding the interior and exterior facades around the main doors to create a more appealing entrance, replacing conventional doors with automatic doors, replacing carpet with ceramic flooring, and upgrading the electrical system, the otherwise deductible costs of the refresh activities were required to be capitalized.

Although applying the "directly benefits or incurred by reason of" standard achieves the goal of replacing the uncertain court-created plan of rehabilitation doctrine with a now more uniform standard, the AICPA believes that the analysis and conclusion illustrated in Temp. Treas. Reg. § 1.263(a)-3T(h)(4), *Example 8*, may lead to an application of the section 263A standard that goes beyond its intended scope. On its face, the standard requires that an expenditure "directly benefit" or be "incurred by reason of" the improvement activity in question, and the preamble states that it is not invoked merely because the repairs and maintenance are performed at the same time as an improvement. However, the fact that many of the refresh activities described in the example that were deductible when standing alone either could not have been factually related to, or beneficial to, the capital remodel activities addressed in the example (or, if they theoretically could be related, the connection was left unstated and ambiguous), implies that many or some of such costs were required to be capitalized merely because they were incurred at the same time as the remodel. Accordingly, the AICPA recommends that this example be modified as follows to specifically indicate that only those refresh costs that were necessary for the taxpayer to complete the improvements were required to be capitalized:

[31] Treas. Reg. § 1.263A-1(e)(3)(i).
[32] Temp. Treas. Reg. § 1.263(a)-3T(h)(4), *Example 8*.

> The taxpayer replaced only certain portions of the ceiling with acoustical tile. The cost of repairs to damaged tiles that were not replaced on other parts of the ceiling neither directly benefitted nor were incurred by reason of the replacement of ceiling tiles and thus were not required to be capitalized. Because the interior and exterior facades were modified only around the main doors, interior painting, and repairing holes in the remainder of the building walls neither directly benefitted nor were incurred by reason of this part of the improvement. Similarly, the taxpayer replaced carpeting with vinyl flooring in some parts of the store. The costs of repairing the vinyl flooring in the remaining parts of the store neither directly benefitted nor were incurred by reason of the improvement activity. Finally, the costs of relocating ceiling lights that were not associated with the built-in changing room relocations neither directly benefitted nor were incurred by reason of that improvement activity.

2. <u>Routine Maintenance Safe Harbor</u>

Temporary Treas. Reg. § 1.263(a)-3T(g)(1) provides that, in general, an amount paid for routine maintenance performed on a unit of property other than a building or a structural component of a building is deemed not to improve that unit of property. Routine maintenance is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of parts of the unit of property with comparable and commercially available and reasonable replacement parts. The activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the ADS class life (as provided under section 168(g)(2) and (3)) of the unit of property.

a. Building Systems

The temporary regulations limit the property to which the routine maintenance safe harbor can be applied to property other than a building or a structural component of a building (or building systems as defined in Temp. Treas. Reg. § 1.263(a)-3T(d)(2)(ii)(A)). The AICPA recommends that the property to which the routine maintenance safe harbor applies be expanded to include building systems. Taxpayers conduct many of the same recurring activities mentioned above (such as inspection, cleaning, and testing) with respect to building systems. For example, with respect to a chiller that is part of a heating, ventilation and air-conditioning (HVAC) system, it is reasonable and likely for a taxpayer to expect to clean, inspect, test, and replace parts on the chiller more than once during its ADS class life. The AICPA believes the routine maintenance safe harbor was meant to apply to this type of normal and recurring maintenance even though performed with respect to a building system. Accordingly, the AICPA recommends that the final regulations permit taxpayers to apply the routine maintenance safe harbor to building systems.

b. Clarify Routine Maintenance Safe Harbor

The AICPA recommends that the final regulations clarify which expenditures qualify for the routine maintenance safe harbor. Specifically, the AICPA suggests that the regulations explicitly state that expenditures that meet the definition of a betterment, as provided by Temp. Treas. Reg. § 1.263(a)-3T(h), or expenditures that meet the definition of a restoration, as provided by Temp. Treas. Reg. § 1.263(a)-3T(i) (except for restorations described in Temp. Treas. Reg. § 1.263(a)-3T(i)(1)(v) and (vi), regarding rebuilding the unit of property to a like new condition and replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property) do not qualify for the routine maintenance safe harbor.

3. Betterments

Temporary Treas. Reg. § 1.263(a)-3T(h) provides that a taxpayer must capitalize amounts paid for activities that result in the betterment of a unit of property. An expenditure results in a betterment of a unit of property if it –

- Corrects a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, without regard to whether the taxpayer was aware of the condition or defect at the time of acquisition or production;[33]
- Results in a material addition to the unit of property (e.g., a physical enlargement, expansion, or extension);[34] or,
- Results in a material increase in capacity, productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.[35]

For purposes of the betterment standard, materiality is determined based on all facts and circumstances including the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on the unit of property, and the taxpayer's treatment of the expenditure in its applicable financial statement.[36]

a. Definition of "Materiality"

The AICPA is concerned that the examples summarily reach conclusions regarding whether the activities constitute a betterment without bright-line tests or safe harbors on which to base such results. The AICPA is concerned that this lack of bright-line tests or safe harbors will lead to continued uncertainty and controversy.

Fundamental to establishing clear rules and reducing uncertainty is the need for a materiality standard, particularly given the underlying factual assumptions in the examples that expenditures do or do not materially improve the building and/or its structural components. Contrast, for example, *Examples 1* and *2* under Temp. Treas. Reg. § 1.263(a)-3T(h)(4) where (1) contaminated soil remediation results in an amelioration of a material defect, thereby constituting a betterment, with (2) the removal of asbestos from a building that does not correct a material defect or a pre-existing condition, permitting the remediation costs to be currently deducted.

[33] Treas. Reg. § 1.263(a)-3T(h)(1)(i).
[34] Treas. Reg. § 1.263(a)-3T(h)(1)(ii).
[35] Treas. Reg. § 1.263(a)-3T(h)(1)(iii).
[36] Treas. Reg. § 1.263(a)-3T(h)(3)(i).

Neither of these examples includes objective data that may be used to evaluate materiality. In addition, Temp. Treas. Reg. § 1.263(a)-3T(h)(4), *Example 7*, does not include a threshold determination of materiality. Often in a retail or other context, bathrooms are insignificant elements of both the building unit of property and the plumbing-system structural component. This fact begs the question of how bathroom fixtures such as toilets, sinks, and plumbing fixtures ever result in a material increase in the quality of a plumbing system when compared to either the building as the unit of property or the individual plumbing system as a structural component. Even a complete bathroom remodel is often an immaterial repair for such taxpayers, both in terms of cost and the fact that such costs merely keep the bathroom in a useable condition.

Without an objective standard to determine materiality, taxpayers will be left to their best efforts to identify what the IRS will find to be material for each expenditure made to repair or maintain a building and its structural components, any of the enumerated building systems, or property other than buildings. This approach will inevitably lead to divergent results between taxpayers and perpetual controversy between taxpayers and the IRS, neither of which furthers the goal of simplifying the tax rules, increasing certainty, or improving compliance.

Given that materiality is inherently subjective and will likely lead to protracted controversies between taxpayers and the IRS, the AICPA strongly encourages Treasury and the IRS to adopt objective materiality standards. Such a standard could be a safe harbor or a single percentage above which expenditures must be capitalized.

If the final regulations do not define materiality with reference to an objective percentage or amount, the AICPA recommends that the IRS and Treasury utilize information from the Industry Issue Resolution (IIR) process to provide examples of material additions and material increases in strength, capacity, productivity, efficiency, quality, or output. The AICPA also suggests that the final regulations provide examples to help address what does or does not constitute a material addition. More substantive examples will help provide taxpayers with a frame of reference when analyzing their expenditures that involve an addition to a unit of property.

The following is illustrative of the type of example that would be helpful for taxpayers:

> *Example:* X pays amounts to enlarge the main lobby of its office building, which included tearing down walls, building new walls and adding flooring. The expenditures increased the amount of wall and flooring space in the lobby by 10 percent, however the total square footage of the building has not increased.
>
> The flooring and walls of the lobby represent a structural component of the building for purposes of determining if an improvement is required to be capitalized.[37] The expenditures increased the amount of wall and flooring space in the lobby by 10 percent (as the size of the lobby increased by 10 percent). A 10 percent increase in the size of the structural component does not constitute a material increase in the size of the structural component, and thus, the addition is not considered a material addition for purposes of determining if the expenditure

[37] Temp. Treas. Reg. § 1.263(a)-3T(e)(2)(ii)(A).

is required to be capitalized as a betterment under Treas. Reg. §§ 1.263(a)-3T(h)(1)(ii) and (h)(2).

b. Clarify "Practicably" Available

Temporary Treas. Reg. § 1.263(a)-3T(h)(3)(ii) provides that if a taxpayer needs to replace a part of a unit of property that cannot practicably be replaced with the same type of part (because of, for example, technological advances or product enhancements), the replacement of the part with an improved, but comparable, part does not, by itself, result in a betterment to the unit of property.[38] Thus, the replacement of an unavailable component with an improved but comparable part does not, by itself, result in a betterment to the unit of property.[39] The 2006 and 2008 Proposed Regulations provided the same rule.[40] In the preamble to the 2006 Proposed Regulations, Treasury and the IRS noted that this rule was "intended to apply in cases where the same replacement part is no longer available, generally because of technological advancements or product enhancements. This rule, however, is not intended to apply if, instead of replacing an obsolete part with the most similar comparable part available the taxpayer replaces the part with one of a better quality than what would have sufficed." This intent is illustrated when *Examples 14* and *15* of Temp. Treas. Reg. § 1.263(a)-3T(h)(4) are read in conjunction with one another, but is not specifically stated in Treas. Reg. § 1.263(a)-3T(h)(3)(ii). To help clarify whether or not the replacement of a part with a comparable part when the same part is not practicably available results in a betterment, the AICPA recommends that the final regulations specifically define "comparable part" or provide factors to consider in evaluating whether a part is a "comparable part." The AICPA also suggests that the final regulations provide that a part is not considered to be practicably available if it is no longer commonly used even though it is possible to obtain.

c. Clarify Examples

The AICPA appreciates the inclusion of numerous examples in the temporary regulations, including the "building refresh" examples in Temp. Treas. Reg. § 1.263(a)-3T(h)(4), *Examples 6, 7* and *8*. Store refreshes and remodels are necessary and frequently recurring activities for retailers. Retailers and other taxpayers must routinely refresh or update the premises at which they conduct business with customers. The appearance and layout of the premises are critical to remain competitive, and attract and retain customers. It is also important to note that such refreshing generally is not a function of whether or not the asset is in a state of nonfunctional disrepair. Rather, it is a function of marketing and providing customers with a pleasant and inviting atmosphere. In this respect, most retail remodels merely keep the retail property in an ordinarily efficient operating condition. In addition, retail premises are fundamentally different from manufacturing facilities, warehouses, general office space, etc., where the building is not the location at which the taxpayer interacts with customers, and appearances do not directly affect sales.

The AICPA suggests that the IRS use Temp. Treas. Reg. § 1.263(a)-3T(h)(4), *Examples 6, 7* and *8*, to illustrate and highlight the intended application and differences of a "plan of rehabilitation"

[38] Temp. Treas. Reg. §§ 1.263(a)-3T(h)(1), (3) and (4), Example 14.
[39] Temp. Treas. Reg. § 1.263(a)-3T(h)(3)(ii).
[40] See 2006 Prop. Treas. Reg. § 1.263(a)-3(d)(4) and 2008 Prop. Treas. Reg. § 1.263(a)-3(f)(2)(ii).

and the section 263A standard to identify whether a cost constitutes an improvement that must be capitalized.

As noted in *Example 6* and in comments above, store refreshes are ordinary and necessary for retailers to remain competitive. Similarly, it is sound business and financial management to undertake other regular maintenance activities at the same time as a store refresh, especially when there is an overlap in service providers or when some or all of the store must be closed to consumers for any period of time. Thus, if a taxpayer undertakes a store refresh and other major maintenance or remodeling at the same time and the expenses relating to the two activities can be accounted for separately, the AICPA believes that taxpayers should be able to undertake both activities contemporaneously without the section 263A standard tainting refresh expenditures that otherwise are deductible, and that the example explicitly state this result.

In *Example 7*, in the course of refreshing its stores, the taxpayer replaces the bathroom fixtures, requiring the capitalization of those expenses as well as the indirect costs of removal and replacement of bathroom tiles. The expenditures relating to the rest of the refresh (outlined in *Example 6*), however, are not implicated and are not required to be capitalized. The example reaches this conclusion based on the assumption that the refresh costs "do not directly benefit and are not incurred by reason of the improvements to the stores' plumbing systems," despite the bathroom update being done "in the course of" the refresh. No other analysis between the refresh and the remodel is provided. The AICPA suggests that, similar to *Example 8*, that *Example 7* include additional analysis demonstrating why the rest of the refresh does not directly benefit and was not incurred by reason of the replacement of bathroom fixtures. Further, the AICPA believes *Example 7* should be modified to indicate that the bathroom is insignificant in relation to the plumbing system and that, accordingly, the replacement of bathroom fixtures does not result in a betterment of the plumbing system. This modification would remove the need to highlight the distinction between costs that do and do not directly benefit and are or are not incurred by reason of an improvement, as well as modify the example to be more consistent with the fact that bathrooms tend to be an insignificant portion of the plumbing system in a building used as a retail store.

Finally, *Example 8* raises an additional concern regarding a store refresh that occurs contemporaneously with other significant changes to the building or its structural components. As discussed above, the AICPA is concerned that this example does not accurately reflect the facts in a retail remodel / refresh. Additionally, the AICPA is concerned that the facts do not fully discuss how the refresh expenses directly benefit or are incurred by reason of the remodel. The AICPA also is concerned that this application of the principles of section 263A to repairs departs from the long-standing application of section 263A to the production of property or inventory. Accordingly, the AICPA believes additional clarifying examples of the section 263A standard should be provided in the final regulations.

4. Replacement of a Major Component under the Restoration Rules

Temporary Treas. Reg. § 1.263(a)-3T(i)(1)(vi) provides that an amount is paid to restore a unit of property if it "[i]s for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property." Temporary Treas. Reg. § 1.263(a)-3T(i)(4) goes on to state that taxpayers should consider all the facts and circumstances that "include the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property." Temporary Treas. Reg. § 1.263(a)-3T(i)(4) defines a major component or substantial structural part to include "a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a discrete and critical function in the operation of the unit of property."

a. Large Portion of a Unit of Property Safe Harbor

The AICPA believes the facts and circumstances approach to determining if a part or a combination of parts comprises a "large portion" of a unit of property may cause undue burden to taxpayers. The AICPA recommends that the IRS and Treasury provide an elective safe harbor method for taxpayers to determine if a part or combination of parts comprises a large portion of a unit of property to help ease the administrative burden and controversy for taxpayers, as well as prevent a potential whipsaw if a taxpayer is required in an examination to capitalize an amount previously deducted as a repair and the statute of limitations is closed for the year of the disposition. The AICPA proposes the safe harbor at a 30 percent threshold and provide that a replacement of a part or a combination of parts is not considered a large portion of a unit of property if –

(1) The cost of the part or combination of parts comprises 30 percent or less of the replacement cost of the unit of property; or,
(2) The part or combination of parts comprises 30 percent or less of the physical structure of the unit of property determined using square footage, volume or any other measure provided in published guidance that is consistently applied.

As an example of the AICPA's recommendation that a safe harbor method be provided for the replacement of a major component or a substantial structural part test, the AICPA suggests Temp. Treas. Reg. § 1.263(a)-3T(i)(5), *Example 8,* be modified to read as follows:

> *Example 8. Replacement of major component or substantial structural part; personal property.* X is a common carrier that owns a fleet of petroleum hauling trucks. X pays amounts to replace the existing engine, cab, and petroleum tank with a new engine, cab, and tank. The new engine and cab cost $25,000. The new tank costs $6,000. The cost of a new tractor is $50,000 and the cost of a new trailer is $30,000. Assume the tractor of the truck (which includes the cab and the engine) is a single unit of property, and that the trailer (which contains the petroleum tank) is a separate unit of property. The amounts paid for the new engine and cab comprise more than 30 percent of the cost of a new tractor and must be capitalized under paragraph (i)(4) of this section. The amounts paid for the new petroleum tank do not comprise more than 30 percent of the cost of a new trailer; however, the tank comprises more than 30 percent of the physical structure of the trailer. Therefore, the amounts paid for the new tank also must be capitalized under paragraph (i)(4) of this section.

b. Discrete and Critical Function Test

Temporary Treas. Reg. § 1.263(a)-3T(i)(4) states that a part or combination of parts is a major component or substantial structural part of a unit of property where the part or combination of parts "comprise a large portion of the physical structure of the unit of property or ... perform[s] a discrete and critical function in the operation of the unit of property." The AICPA believes the discrete and critical function test should not apply in the context of a building structure apart from the eight enumerated building systems defined in Temp. Treas. Reg. § 1.263(a)-3T(e)(2)(ii)(B). The application of the discrete and critical function test to a building structure may lead to confusion. In addition, the AICPA believes that the "large portion of the physical structure" requirement adequately addresses situations where capitalization is required for a building structure or building system.

Temporary Treas. Reg. § 1.263(a)-3T(i)(5), *Example 14*, is ambiguous as to whether the discrete and critical function test is being applied to determine if the roof membrane is a major component or substantial structural part of the building's structure. Under the AICPA's recommendation that the discrete and critical function test not apply to building structures or systems, the AICPA suggests *Example 14* be modified to read as follows:

> *Example 14. Not replacement of major component or substantial structural part; roof membrane.* X is in the business of manufacturing parts. X owns a factory facility in which the parts are manufactured. The roof over X's facility is comprised of structural elements, insulation, and a waterproof membrane. Over time, the waterproof membrane began to wear and leakage began to occur. Consequently, X pays an amount to replace the plant's worn roof membrane with a similar but new membrane. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The roof, including the membrane, is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Although the roof membrane may be a large portion of the roof, it is not, by itself, a major component or substantial structural part of X's building structure under paragraph (i)(4) of this section. Because the roof membrane is not a major component or substantial structural part of the building structure, X is not required to treat the amount paid to replace the roof membrane as a restoration of the building structure under paragraph (i)(1)(vi) of this section.

The suggested modifications to this example further illustrate that taxpayers should only look to a major component or substantial structural part of a unit of property, and do not need to identify subcomponents to determine whether the replaced property must be capitalized as a restoration. The AICPA also recommends that Temp. Treas. Reg. § 1.263(a)-3T(i)(4) be modified to indicate that taxpayers do not need to identify subcomponents of components.

Eliminating the discrete and critical function test for building structures would necessitate the following modifications to *Examples 23* through *26:*

> *Example 23. Not replacement of major component or substantial structural part; windows.* X owns a large office building that it uses to provide office space for employees that manage X's operations. The building has 300 exterior windows. In Year 1, X pays an amount to replace 30 of the exterior windows that had become damaged. At the time of these replacements, X has no plans to replace any other windows in the near future. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The exterior windows are part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. The 30 replacement windows do not comprise a large portion of the physical structure of the office building structure. Therefore, under paragraph (i)(4) of this section, the replacement windows do not constitute a major component or substantial structural part of the building structure. Accordingly, X is not required to treat the amount paid to replace the windows as a restoration of a building system under paragraph (i)(1)(iv) of this section.
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> *Example 24. Replacement of major component or substantial structural part; windows.* Assume the same facts as *Example 23* except that X replaces 200 of the 300 windows on the building. In addition, as a result of damage caused during the window replacements, X also pays an amount to repaint the interior trims associated with the replaced windows. The 200 replacement windows comprise a large portion of the physical structure of X's building. Therefore, under paragraph (i)(4) of this section, the 200 windows comprise a major component or substantial structural part of the building structure, and X must treat the amount paid to replace the windows as a restoration of the building structure under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid to restore the building structure (i.e., the replacement and directly-related repainting costs) as an improvement to the building and must capitalize the amounts under paragraph (d)(2) of this section.
>
> *Example 25. Not replacement of major component or substantial structural part; floors.* X owns and operates a hotel building. X decides to refresh the appearance of the hotel lobby by replacing the floors in the lobby. The hotel lobby comprises a small portion of the entire hotel building. X pays an amount to replace the wood flooring in the lobby with new wood flooring. X did not replace any other flooring in the building. Assume that the wood flooring constitutes section 1250 property. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The wood flooring is part of the building structure under

paragraph (e)(2)(ii)(A) of this section. The replacement wood flooring in the lobby of the building does not comprise a large portion of the physical structure of the hotel building. Therefore, under paragraph (i)(4) of this section, the wood flooring does not constitute a major component or substantial structural part of the hotel building structure. Accordingly, X is not required to treat the amount paid to replace the wood flooring in the hotel lobby as a restoration under paragraph (i)(1)(vi) of this section.

Example 26. Replacement of major component or substantial structural part; floors. Assume the same facts as *Example 25* except that X decides to refresh the appearance of all the public areas of the hotel building by replacing the floors. To that end, X pays an amount to replace all the wood floors in all the public areas of the hotel building with new wood floors. The public areas include the lobby, the hallways, the meeting rooms, and other public rooms throughout the hotel interiors. The replacement wood floors in all the public areas comprise a large portion of the physical structure of the hotel building structure. Therefore, under paragraph (i)(4) of this section, the replacement wood floors comprise a major component or substantial structural part of the building structure, and X must treat the amount paid to replace the floors as a restoration of the building structure under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid to restore the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(2) of this section.

c. Clarify Examples

Temporary Treas. Reg. § 1.263(a)-3T(i)(4) provides that "[a] major component or substantial structural part [of a unit of property] includes a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a discrete and critical function in the operation of the unit of property." Although the regulation states that taxpayers need only determine if the part(s) comprise a large portion of the unit of property *or* perform a discrete and critical function, *Examples 20, 22, 24*, and *26* all state that the parts replaced in the respective examples perform discrete and critical functions *and* that the replacement parts comprise a large portion of the physical structure of the respective building structure or system.

The AICPA recommends the IRS and Treasury modify these examples to clearly illustrate that the taxpayer need only meet either the large portion *or* discrete and critical function test for the part(s) to be considered a major component or substantial structural part of a unit of property. In addition, the AICPA recommends that *Example 22* be modified to have similar facts and conclusions as *Moss v. Commissioner*.[41] Accordingly, suggested modifications to *Example 22* provide that the activity in the example is implemented pursuant to a written plan that is not a plan of rehabilitation, and that routine maintenance

[41] 831 F.2d 833 (9th Cir. 1987).

activities are not required to be capitalized. In this regard, the AICPA suggests that *Examples 20* and *22* be modified to read as follows:

> *Example 20. Not replacement of major component or substantial structural part; plumbing system.* X owns a building in which it conducts a retail business. The retail building has three floors. The retail building has men's and women's restrooms on two of the three floors. X decides to update the restrooms by paying an amount to replace the plumbing fixtures in all of the restrooms, including the toilets, sinks, and associated fixtures, with modern style plumbing fixtures of similar quality and function. X does not replace the pipes connecting the fixtures to the building's plumbing system. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The plumbing system, including the plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(2) of this section. In this instance, the plumbing fixtures in all the restrooms do not comprise a large portion of the physical structure of the plumbing system. Moreover, the plumbing fixtures do not perform a discrete and critical function within the plumbing system. Therefore, under paragraph (i)(4) of this section, the plumbing fixtures do not comprise a major component or substantial structural part of the plumbing system, and X is not required to capitalize the costs to replace the plumbing fixtures under paragraph (i)(1)(vi) of this section.
>
> *Example 22. Replacement of major component or substantial structural part; remodel.* (i) X owns and operates a hotel building. X decides that to attract customers and to remain competitive, it needs to maintain the quality standard expected by its customers and updates the guest rooms in its facility pursuant to a written plan. Accordingly, X pays amounts to remodel guest room bathrooms; the work includes replacing the bathtubs, toilets, sinks, plumbing fixtures, and to repair, repaint, and retile the bathroom walls and floors, which was necessitated by the installation of the new plumbing components. The replacement bathtubs, toilets, sinks, plumbing fixtures, and tile are new and in a different style, but are similar in function and quality to the replaced items. X also pays amounts to replace certain section 1245 property, such as the guest room furniture, carpeting, drapes, table lamps, and partition-walls separating the bathroom area. In addition, as part of its routine and recurring maintenance, X repairs, repaints, and re-wallpapers other portions of guest rooms. In Year 1, X pays amounts to perform the updates for eight of the twenty hotel room floors, and expects to complete the renovation of the remaining rooms over the next 2 years.
>
> (ii) Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The plumbing system, including the bathtubs, toilets, sinks, and plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(2) of this section. In this instance, the bathtubs,

toilets, sinks, and plumbing fixtures in the hotel building also comprise a large portion of the physical structure of plumbing system. Therefore, under paragraph (i)(4) of this section, these plumbing components comprise major components or substantial structural parts of the plumbing system, and X must treat the amount paid to replace these plumbing components as a restoration of a building system under paragraph (i)(1)(vi) of this section. Under paragraph (f)(3)(i) of this section, X must treat the costs of repairing, repainting, and retiling the bathroom walls and floors necessitated by replacing plumbing components as improvement costs because these costs directly benefit and are incurred by reason of the improvement to the plumbing system. Further, under paragraph (f)(4) of this section, X must treat the costs incurred in Years 1, 2, and 3 for the bathroom remodeling as improvement costs, even though they are incurred over a period of several taxable years, because they are part of the aggregate of related amounts paid to improve the plumbing system. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts it paid to improve the plumbing system as the costs of improving the building and must capitalize the amounts under paragraph (d)(2) of this section. In addition, X must capitalize the amounts paid to acquire and install each section 1245 property under § 1.263(a)-2T of the regulations. Costs related to repairing, repainting, and re-wallpapering other portions of guest rooms to maintain the quality of the guest rooms that are not necessitated by the replacement of plumbing components do not directly benefit and were not incurred by reason of the bathroom remodel, and are not required to be capitalized under paragraph (f)(3)(i) of this section. Further, these costs are not required to be capitalized under paragraph (i)(1)(vi) of this section.

The AICPA recommends that *Examples 24* and *26* be modified similar to the proposed modifications to *Examples 20* and *22* above. The modifications recommended here to *Examples 24* and *26* are in addition to the prior recommendations for modifications to those examples for the discrete and critical function test.

5. Adaptation Rule Examples

The AICPA believes that the final regulations should provide additional examples to clarify how the adaptation rule of Temp. Treas. Reg. § 1.263(a)-3T(j) applies in situations where a taxpayer incurs costs to update real or personal property for marketing purposes where the costs neither add to the useful life of the property nor improve the property. The following example illustrates this concept:

Example: X is an automobile dealer that owns the building it uses as an automobile showroom. During the taxable year, X changes from carrying Brand A automobiles to carrying Brand B automobiles. X incurs costs to convert its showroom colors and layout from Brand A to Brand B. For example, X incurs costs to repaint with Brand B's color scheme, refinish floors, and move furniture and fixtures to reflect the Brand B layout. Under paragraph (j)(1) of this section, the reconfiguration and cosmetic changes do not adapt X's building to a new or different use. Both before and after the rebranding activities, the building was used as an automobile showroom. Therefore, the costs incurred by X for rebranding do not adapt the building to a new or different use. Additionally, the rebranding costs are not a betterment under paragraph (h) of this section, as the rebranding activities do not materially increase the physical size of the building, or increase the output, quality, strength, or efficiency of the building.

6. Removal Costs

The preamble to the temporary regulations states that the temporary regulations do not include a specific rule for the treatment of costs associated with removing an asset, but that the costs of removing a component of a unit of property should be analyzed in the same manner as any other indirect cost incurred during an improvement to property. Thus, similar to the treatment of otherwise deductible repair and maintenance costs incurred during an improvement, the costs of removing a component of a unit of property must be capitalized if they directly benefit or are incurred by reason of an improvement to a unit of property. See, for example, *Tonawanda Coke Corp. v. Commissioner*[42] (holding that costs of removing piping damaged in a fire and installing new pipe were capital expenditures); *Phillips Easton Supply Co. v. Commissioner*[43] (holding that costs of removing a cement floor in a building and replacing it with a concrete floor were capital expenditures to improve the property); Rev. Rul. 2000-7[44] (providing that the costs of removing a component of a depreciable asset are either capitalized or deducted based on whether the replacement of the component constitutes an improvement or a repair).

The preamble to the temporary regulations states that a taxpayer may deduct the costs of removing a component if the taxpayer can demonstrate that such costs relate only to the disposition of the removed property and that the costs do not have the requisite relationship to any improvement. More importantly, the preamble specifically states that the temporary regulations do not affect the holding of Rev. Rul. 2000-7 as it applies to the costs of removing an entire unit of property.

Under Rev. Rul. 2000-7, a taxpayer is not required to capitalize the cost of removing a retired depreciable asset under either section 263(a) or 263A, even where the retirement and removal occurred in connection with the installation of a replacement asset. Historically, the costs of removing a depreciable asset generally have been allocable to the removed asset, and thus generally have been deductible when the asset is retired.[45] The preamble to the temporary regulations notes that because the costs of removing a retired asset typically relate to the depreciable asset being removed and are not allocable to the improvements, Temp. Treas. Reg. § 1.263(a)-3T generally is not applicable to such removal costs.

Although the preamble states that the temporary regulations do not affect the holding of Rev. Rul. 2000-7, the AICPA recommends that the final regulations clarify the interplay between the new disposition rules, the application of the section 263A standard, and the holding of Rev. Rul.

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[42] 95 T.C. 124 (1990).
[43] 20 T.C. 455 (1953).
[44] 2000-1 C.B. 712.
[45] See Treas. Reg. §§ 1.165-3(b), 1.167(a)-1(c), 1.167(a)-11(d)(3)(x); Rev. Rul. 74-455, 1974-2 C.B. 63; Rev. Rul. 75-150, 1975-1 C.B. 73.

2000-7. Specifically, the preamble states that the cost of removing a component of an asset must be capitalized if the replacement of the component is required to be capitalized as an improvement. This appears to establish a per se rule that the removal of a component of an asset will be deemed to directly benefit or be incurred by reason of a replacement that occurs at the same time. Such a conclusion appears to be at odds with the rationale and authorities that supported the holding of Rev. Rul. 2000-7. Although the holding is limited to removal costs associated with the removal of an entire asset, in support of the holding, the IRS reasoned that the costs of removing an asset have been historically allocable to the removed asset, and thus, generally deductible when the asset is retired and the costs are incurred. The IRS cited as authority the provisions of the Code and regulations that permit a loss deduction upon the permanent withdrawal of depreciable property from use in a trade or business or the physical abandonment of property.[46] Thus, the holding of the ruling appears to be in part predicated on the fact that the taxpayer was entitled to a loss deduction for the adjusted basis of the asset that was removed and this made the removal costs more closely associated with the taxable event (the disposition of the asset) than with the replacement.

Because the temporary regulations, in the case of buildings and certain other property described in Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii)(F), have expanded the definition of a disposition for purposes of the loss provisions for depreciable property beginning in 2012 to include the disposition of "each structural component" of a building[47] or "component" of certain other property,[48] the AICPA believes the temporary regulations should be revised to explicitly acknowledge that for purposes of applying the rationale and holding of Rev. Rul. 2000-7, the unit of property for disposition purposes is properly treated as the unit of property.[49] As a result, any removal costs associated with the disposition of a structural component of a building or each taxpayer-identified component of certain other property, to the extent the adjusted basis of the removed component is allowable as a loss deduction, should be allocable to the removed component.

7. <u>Election to Capitalize Repairs</u>

The AICPA suggests that the final regulations permit taxpayers to elect to capitalize repair expenditures as improvements. In situations where such costs are capitalized for financial accounting purposes, it may be difficult for taxpayers to identify and calculate these costs for federal income tax purposes even though capitalization would not be required after applying the improvement standards. Having the option to elect to capitalize these amounts notwithstanding that the improvement standards would not require capitalization would provide taxpayers with the flexibility to follow their financial accounting methods where such methods overcapitalize repair expenditures and they are unable to segregate such costs for federal income tax purposes. This would promote administrability and reduce the cost of compliance with the regulations. The AICPA recommends that such election be made on an annual basis, and with respect to all or a portion of a taxpayer's otherwise deductible repairs (e.g., similar to the election provided

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[46] Section 165(a); Treas. Reg. §§ 1.165-2(c) and 1.167(a)-8(a).
[47] Temp. Treas. Reg. § 1.168(i)-8T(b)(1).
[48] Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii)(F).
[49] The AICPA believes this is the proper interpretation of Rev. Rul. 2000-7 because the rationale is dependent on the existence of a recognition event for the item being removed, which is more consistent with the unit of property being disposed of than the unit of property used for any other purpose.

under Temp. Treas. Reg. § 1.162-3T(d)(1) for materials and supplies or Temp. Treas. Reg. § 1.263(a)-2T(f)(2)(iv)(B)).

F. Dispositions / General Asset Accounts

1. <u>Elective Disposition of Structural Components of a Building</u>

Under Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii), each building and structural component (including all components thereof) is treated as a separate asset. It is unclear to what level of detail a taxpayer must go to determine the asset replaced (e.g., whether a taxpayer must look to every door, window and shingle replaced in order to determine the asset that was disposed of). The rules under Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii) provide no guidance on determining when a taxpayer is required to dispose of a component of a structural component, or if it has the flexibility to determine that a disposition has not occurred when replacing, for example, one window in a building that has 300 windows. An improper application of these rules could result in a permanent loss of the taxpayer's deduction. This rule does not appear to distinguish between a minor repair and a replacement of a major component or substantial structural part.

An example in the restoration rules illustrates the complexity of this rule. Specifically, Temp. Treas. Reg. § 1.263(a)-3T(i)(5), *Example 23*, outlines the facts where a taxpayer owns a large office building with 300 exterior windows and replaces 30 of the windows that have become damaged. Based on the facts presented, the conclusion reached is that the replacement of the 30 windows does not constitute a major component or substantial structural part of the building and therefore does not constitute a capitalizable restoration. Under the disposition rules, however, the taxpayer is required to dispose of the 30 windows because they constitute a structural component of the building (see, e.g., Temp. Treas. Reg. § 1.168(i)-8T(h), *Example 1* (taxpayer required to recognize loss upon replacement of one out of four elevators), and *Example 5* (taxpayer required to recognize loss upon replacement of one elevator in multi-story office building)), and, based on the fact that they were disposed of, would be required to capitalize the replacement pursuant to Temp. Treas. Reg. §§ 1.263(a)-3T(i)(1) and (i)(2). As an additional complication, if the taxpayer had not placed the building into a general asset account in order to not recognize the loss on the windows replaced, the loss that should have been recognized could be permanently disallowed because the loss was not claimed in the proper year. If the taxpayer had made a general asset account election for the building when it was placed in service, the taxpayer would recognize no loss on the disposition and would claim a repair expense deduction because the replacement of 30 windows is not an improvement. Taxpayers that do not make the general asset account election and are unaware of the mandatory requirements to take a loss on the disposal of components of a larger unit of property can have unintended consequences such as the disallowance of depreciation deductions on assets that had previously been disposed of, coupled with having to take a loss on disposal in a year closed by statute. In addition, the taxpayer must now determine the asset (component) that is being capitalized (e.g., a group of 30 windows or each individual window) in order to determine the basis of those asset(s), and track when that specific item has been replaced. Having to track assets at that level of detail likely will be extremely burdensome for taxpayers.

The AICPA suggests that one way to eliminate the administrative burden and the potential for inadvertent errors is to permit taxpayers to elect to treat retirements of structural components of buildings as a disposition of MACRS property rather than making such treatment mandatory.[50] This would provide the same certainty and flexibility that is afforded under the temporary regulations, but would eliminate the potential for inadvertently failing to claim a disposition loss or failing to make a GAA election (and related qualifying disposition election).

2. Clarify Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii)(C)

The preamble to the temporary regulations notes that a taxpayer that elects general asset accounting has the option of recognizing gain or loss on an expanded list of qualifying dispositions. These options under the general asset account and disposition rules apparently are added to provide flexibility in applying certain of the improvement standards under Temp. Treas. Reg. § 1.263(a)-3T. The increased flexibility results in added complexity and a greater likelihood that taxpayers will either fail to comply with the temporary regulations, or fail to apply the rules in the most favorable manner because they either do not understand or misapply the disposition rules.

Temporary Treas. Reg. § 1.168(i)-8T provides that the determination of an asset disposed of generally is based upon the facts and circumstances of each disposition. The asset for disposition purposes cannot be any larger than the unit of property defined under Temp. Treas. Reg. §§ 1.263(a)-3T(e)(2), (e)(3) and (e)(5). Thus, taxpayers have flexibility in determining the asset disposed of. This flexibility is illustrated in Temp. Treas. Reg. § 1.168(i)-8T(h), *Examples 2* and *3*. In *Example 2*, a taxpayer owns a fleet of aircraft and replaces the engines on one of the aircraft. In this example, for disposition purposes, the taxpayer treats as a separate asset the engine(s) of the aircraft, so upon replacement the taxpayer is required to dispose of the old engines and capitalize the new engines. In *Example 3*, the only fact that changes is the taxpayer treats the entire aircraft as the asset for disposition purposes. Under such facts the taxpayer does not dispose of the old engines, and conversely is not required to capitalize the new engines as separate assets.

Notwithstanding the general rule described above, Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii)(A) and (C), respectively, provide that for purposes of the disposition rules, each building (not including its structural components) is the asset and each structural component (including all components thereof) of a building is the asset. For this purpose, the definitions under Treas. Reg. §§ 1.48-1(e)(1) and (e)(2) apply. Specifically, Treas. Reg. § 1.48-1(e)(2) defines structural components as parts of the building "including walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors, all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system,

[50] Other commentators have suggested an alternative approach under which a taxpayer would be permitted to elect to recover the basis of a replaced component if the cost of the replacement component is required to be capitalized. *See, e.g.,* Ivins, Phillips & Barker letter to the IRS dated April 9, 2012 (2012 TNT 84-17), which suggests an "approach that whenever a taxpayer is required to capitalize a replacement part or component of a unit of property for whatever reason, and at whatever the point in time in the tax administration process that occurs, the taxpayer is entitled to claim an offsetting deduction for the adjusted basis of the replaced part or component, if the taxpayer so desires." The AICPA believes that such an approach would be less administratively burdensome for taxpayers than the temporary regulation provisions.

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." However, the temporary regulations do not define what constitutes a component of a structural component.

It is not clear from the temporary regulations whether a taxpayer is required to identify components of structural components, or whether the structural components include all of the components that make up that structural component. The AICPA recommends that the final regulations clarify that it is the latter. Further, the AICPA suggests that the final regulations clarify that under Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii), a taxpayer may choose to treat a component of a structural component as the asset disposed of. The AICPA believes the final regulations should make it clear that it is at the taxpayer's discretion to choose to identify the asset disposed of as being smaller than the structural component, and that the IRS cannot require a taxpayer to treat a component of a structural component as the asset disposed of unless required under Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii)(D) or (E).

The AICPA recommends that the final regulations provide guidance as to the definition of a component of a structural component. The AICPA believes such definition should be framed in a manner that would allow for flexibility in defining the component. For example, the definition could be stated as a percentage of the structural component (e.g., 80 percent of a roof), a portion of the structural component (e.g., linear feet of piping in a plumbing system), or an individual subcomponent (e.g., a window pane). As there are reasonable methods (such as through a cost segregation analysis) of quantifying the adjusted basis of percentages or other portions of structural components, this flexibility could ease the burden of determining the amount to take as a disposition loss, (e.g., replacement of 80 percent of the roof is a capital expenditure, and thus, the taxpayer can define 80 percent of the roof as a component of the roof, and take a disposition loss for this "asset" under Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii)(C) or (F)). The AICPA also recommends that the final regulations illustrate how the "consistency" requirement under Temp. Treas. Reg. § 1.168(i)-8T(c)(4)(ii)(F) applies in this context (e.g., whether the requirement would apply to require the taxpayer to continue to classify the asset with respect to the component of the roof as 80 percent of the roof, or would permit the taxpayer to use another appropriate percentage with regard to a future disposition).

3. <u>Determination of the Basis of a Component</u>

The temporary regulations require a taxpayer to compute the adjusted basis of the asset disposed of. This computation may be challenging for a taxpayer where the asset is a structural component (including components thereof) of a building where the taxpayer previously has not tracked the adjusted basis of each structural component (including components thereof). Thus, in the example discussed above, the taxpayer would not have recorded each individual window as a separate asset, and as a result upon replacement of the 30 windows the taxpayer would not have readily available the adjusted tax basis of the windows replaced. The temporary regulations allow taxpayers to use any reasonable method to allocate basis to the asset being disposed of. The AICPA suggests that the IRS and Treasury provide examples of reasonable methods taxpayers might use that would be acceptable to the government. One such method that would reduce the administrative burden would be to use, as a base cost, the replacement cost of the item(s) being replaced and apply an inflation factor to restate that cost back to when the item was first placed in service. Using the 30 window example above, if the taxpayer paid $15,000 to have the windows replaced and those windows had been placed in service 10 years ago, the taxpayer could use a published index (e.g., the Consumer Price Index for Durable Goods published by the Bureau of Labor Statistics) to determine the inflation or deflation over that 10-year period to restate the $15,000 cost to the estimated original cost of the windows. Under the specific facts outlined above, the taxpayer would divide the published index for the year the replacement occurred with the index for the year the item was placed in service to determine the factor to be applied to the replacement cost.

For illustrative purposes, assume that the inflation rate over the 10-year period is 10 percent. The $15,000 paid to replace the windows would be divided by 1.10 to determine the cost of the windows replaced, which would be $13,636. The $13,636 would be the cost assigned to the 30 windows disposed of, and the taxpayer would determine what depreciation had been taken on the windows to calculate the adjusted basis to compute the loss of $10,329 ((13,636 – (13,636 * 0.24253)).[51] The taxpayer would claim a loss of $10,329 and capitalize $15,000.

The IRS and Treasury may also want to consider a simpler alternative under which the original cost of the component represents the same percentage of the cost of the unit of property that the component bears to the unit of property today. Thus, if the component represents 5 percent of the total cost of the unit of property based on current data, then the original cost of the component is presumed to equal 5 percent of the original cost of the unit of property.

Additional alternative approaches could include the use of cost segregation data provided by third parties such as RS Means or other similar services.

G. Method Change Guidance – Revenue Procedures 2012-19 and 2012-20

The AICPA commends the IRS and Treasury for providing automatic method changes to comply with the temporary regulations. Additionally, the AICPA believes the waiver of the scope limitations for two years will allow taxpayers additional time to comply with the complex rules provided in the temporary regulations. However, the AICPA has identified a number of areas in the Method Change Guidance that should be revised or clarified.

1. <u>Change in Accounting Methods for the De Minimis Rule</u>

Under Rev. Proc. 2012-19, a taxpayer receives automatic consent for a change to use the de minimis rule. However, it is not clear whether a taxpayer that is currently using a method that is consistent with the de minimis rule in Temp. Treas. Reg. § 1.263(a)-2T(g) (e.g., where the taxpayer uses a de minimis rule under which its facts could not exceed the ceiling limitation), is required to file a method change request. Additionally, it is not clear whether a taxpayer that changes its book minimum capitalization amount is required to request consent to change its method of accounting, even though it continues to employ the de minimis rule as set forth in

[51] Depreciation percentage assumes the windows are 39-year property that was placed in service in June and the applicable mid-month convention is applied. As a result, the percentage is equal to 5.5 months plus 9 years divided by 39 years.

Temp. Treas. Reg. § 1.263(a)-2T(g). The AICPA suggests that the government provide guidance that a change in the book minimum capitalization amount is not a change in method of accounting for federal income tax purposes. The de minimis rule is required to be used by a taxpayer that meets the requirements and does not otherwise elect to capitalize amounts subject to the de minimis rule. A taxpayer's compliance with such rule should not be burdened with a filing requirement, for which the failure to comply with has no impact to the government. Presumably a change in the taxpayer's AFS capitalization policy is a change in underlying facts, and would not be effectuated with a section 481(a) adjustment. It will be readily apparent to an IRS examiner that the taxpayer's AFS minimum capitalization threshold has changed. The requirement for taxpayers to file a form or statement is an administrative procedure that likely will be fraught with inadvertent noncompliance. Accordingly, the AICPA strongly recommends that a change in an AFS capitalization policy not be treated as a change in method of accounting. If, however, the government determines that a taxpayer's change in its AFS minimum capitalization threshold is a change in accounting method, the AICPA recommends that the change be implemented on a cut-off basis, and by including a statement in the taxpayer's return in lieu of filing a Form 3115, *Application for Change in Accounting Method*. Additionally, the AICPA recommends that any guidance requiring such filing make it clear that if a taxpayer otherwise complies with the de minimis rule, the failure to attach such statement will not cause a taxpayer to be ineligible for the de minimis rule computed using the new AFS minimum capitalization threshold.

The AICPA is also aware of a number of taxpayers that would be eligible for the de minimis rule, but for the requirement of having a written capitalization policy in effect on the first day of the taxpayer's taxable year. The AICPA suggests that the government consider providing transitional relief to comply with the written policy provision for a taxpayer's first taxable year beginning after December 31, 2011. If such relief is not granted, the AICPA recommends that the government clarify whether a taxpayer that had not previously deducted amounts under a minimum capitalization policy that was precluded from the changing to the de minimis rule solely by virtue of not having a written capitalization policy as of the first day of its taxable year, must file an accounting method change or would be considered to adopt a method of accounting because of a change in underlying facts.

2. <u>Use of Statistical Sampling</u>

Revenue Procedures 2012-19 and 2012-20 provide language on the scope of and methodologies for statistical sampling under the temporary regulations. The AICPA commends the IRS and Treasury for permitting the use of statistical sampling in complying with the temporary regulations. However, the guidance creates uncertainty by stating that "[s]ampling methodologies not described in Rev. Proc. 2011-42 are not permitted." Revenue Procedure 2011-42 provides specific methodologies the IRS will accept as statistically valid, but also says "[i]t is recognized that existing industry practices and specific taxpayers may be using techniques that are not covered by this revenue procedure. If a taxpayer employed a probability sample or method not covered by this revenue procedure, then the estimate may be referred to a Statistical Sampling Coordinator for resolution or issue development."

The AICPA understands that IRS Statistical Sampling Coordinators have been informed that they will continue to have the same latitude to accept statistical techniques not covered by Rev.

Proc. 2011-42 as before (such as model-based sampling); however, this information has not been published and many taxpayers may be unsure of how to proceed in those instances where alternative statistical sampling methods are substantially more efficient for both taxpayers and the IRS. The AICPA recommends that the IRS issue additional guidance clarifying that Rev. Proc. 2012-19 and Rev. Proc. 2012-20 do not place new limitations on what the Statistical Sampling Coordinators may accept for purposes of the temporary regulations. Because practitioners are currently using model-based sampling methodologies for taxpayers, this matter has some urgency, and the AICPA asks that the IRS quickly provide written clarification in a notice or announcement to eliminate uncertainty for both taxpayers and examination teams.

Similarly, Rev. Proc. 2012-19 and Rev. Proc. 2012-20 enumerate those accounting method changes where statistical sampling may be used, but are silent on the use of statistical sampling when describing others. The AICPA understands that the IRS' intent is to allow examination teams the discretion to accept the use of statistical sampling for any accounting method change contained in these revenue procedures, including those where sampling is not specifically mentioned. The AICPA believes that taxpayer and IRS examination team uncertainty would be reduced if this understanding were to be clarified in further guidance and asks that such guidance be issued.

More specifically, since the issuance of the revenue procedures, taxpayers have frequently expressed concern over the complexity of applying the de minimis rule, and whether the use of statistical sampling is appropriate. Given the many general ledger accounts and subaccounts within which potential de minimis expenditures may be recorded, as well as the commingling of many different kinds of expenditures within these same accounts, statistical sampling may be the only viable way for some taxpayers to ascertain and demonstrate if either the gross receipts or depreciation and amortization threshold has been meet. Similarly, because statistical sampling may be the only way to examine whether some taxpayers have met the applicable threshold, compliance will be simplified if the IRS clarifies that statistical sampling is an acceptable methodology for both taxpayers and the IRS.

Taxpayers would find examples of the application of statistical sampling useful in future guidance. Although Rev. Proc. 2007-35 discusses statistical sampling for purposes of section 199, the AICPA believes it provides a roadmap for constructing examples of the appropriate use of statistical sampling in complying with the temporary regulations. One area of taxpayer concern that could be explored through an example is the need to track and determine the remaining basis of dispositions. Here, an acceptable method would be to use a statistical sample to first determine which expenditures for a building's structural components require capitalization, and then to determine whether those same sample units are associated with the disposition of a prior capital expenditure. Such an example also could illustrate acceptable methods for estimating the remaining basis of the asset and applying that remaining basis to the same sample unit. One acceptable method would follow cost segregation approaches outlined in Chapter 3 of the IRS' "Cost Segregation Audit Techniques Guide." The AICPA would be pleased to assist in the development of appropriate examples and methodologies based on standard industry guides.

3. Extrapolation of Test Period Results to Prior Years

The AICPA understands that one of the primary goals of the temporary regulations is to minimize controversy over tangible property capitalization issues. The AICPA believes this goal would be furthered if extrapolation procedures were permitted as an elective alternative. Although the use of extrapolation has been most commonly discussed in the context of repair and improvement expenditures, extrapolation is equally important for complying with the disposition rules and other provisions in the temporary regulations that require a section 481(a) adjustment to effectuate the change. The IRS and Treasury have previously permitted extrapolation in a number of areas (e.g., Treas. Reg. § 1.263A-7(c) (concerning revaluation of inventory costs under the uniform capitalization rules) and Rev. Proc. 2011-43 (concerning a safe harbor method for utility transmission and distribution property). The need for extrapolation procedures is evident based on the nature and recovery periods of the tangible property subject to the temporary regulations coupled with the fact that many taxpayers have undergone system changes in recent years and may be unable to obtain accurate data as far back as necessary to support a consistent method of accounting, whether based on a statistical sample within the guidelines of Rev. Proc. 2011-42 or some other reasonable method.

The AICPA believes the IRS and Treasury could look to the prior extrapolation procedures in developing an appropriate extrapolation model for taxpayers changing their accounting methods to comply with the temporary regulations. For example, the extrapolation procedures provided in Rev. Proc. 2011-43, concerning electric transmission and distribution property repairs, could be used as a starting point for the extrapolation procedures for method changes to comply with the temporary regulations. Revenue Procedure 2011-43 provides an extrapolation procedure allowing taxpayers to test expenditures for a minimum period of at least three consecutive years, including the year of the accounting method change, and applying a resulting adjustment rate to earlier years.[52] The adjustment rate reflects the difference between the taxpayer's existing and new capitalization policies as a percentage of capital expenditures, per the taxpayer's financial records. Revenue Procedure 2011-43 mandates a haircut to the adjustment for periods when the rate is applied.[53]

The AICPA strongly recommends adoption of an extrapolation procedure for electing taxpayers to substantially reduce administrative burdens for those seeking to bring their historical expenditures into compliance with the temporary regulations. To the extent the government is concerned about the validity of prior years' data or the variability of repairs or capital improvement expenditures during the testing period and the extrapolation period, the government could require a longer minimum period (e.g., a minimum of five years versus three years) and/or impose a haircut percentage (e.g., initial haircut limited to no more than five percent and the total haircut applied to the earliest years to which results are extrapolated capped at 15 percent) to mitigate those risks. Alternatively, the test years could be adjusted to address anomalies. The

[52] The AICPA notes that in considering an extrapolation methodology the use of the year of change as part of the minimum period presents computational changes. Accordingly, the AICPA suggests that any testing period end with the tax year immediately prior to the beginning of the tax year of change (e.g., the three tax years immediately preceding the tax year of change).

[53] The required reduction to the adjustment is consistent with case law, which allowed the use of estimation, but required the taxpayer to adopt a conservative position. See, e.g., *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

AICPA notes that in Rev. Proc. 2011-43, the minimum haircut is 10 percent and it increases quickly with the number of years to which it is applied. Further, when statistical sampling is used, the result may be subject to an additional haircut if the 10-percent relative precision threshold in Rev. Proc. 2011-42 is not achieved. The potential for a double haircut when using extrapolation is counterproductive and will discourage its use. The AICPA would appreciate the opportunity to assist the IRS and Treasury in developing extrapolation procedures that alleviate the administrative burden of complying with the temporary regulations and manage the risks to the government in permitting such extrapolation procedures.

The AICPA requests that guidance allowing any extrapolation procedures make clear that it is allowed solely at the election of the taxpayer and that the extrapolation procedures cannot be unilaterally imposed by an IRS examination team. The AICPA believes that the IRS should not have the authority to mandate the use of an extrapolation procedure to other years, particularly when other taxpayer records may exist.

4. Additional Items

a. General Asset Account Elections and Concurrent Qualified Disposition Method Change

The guidance in Rev. Proc. 2012-20 is unclear regarding how many Forms 3115 need to be filed when a taxpayer wants to change to a method of accounting to make a late GAA election[54] for an item of modified accelerated cost recovery system (MACRS) property and a method change to recognize a loss upon the prior disposition of an asset that was once part of the same item of MACRS property. The need for additional guidance can be illustrated by applying the rules as currently written to the following factual situation:[55]

- In 1990, Taxpayer places a building and its structural components into service and does not make a GAA election with respect to the building or its structural components.
- In 2000, Taxpayer replaces the entire roof on the building. Taxpayer did not recognize a loss on the retirement of the old roof and continues to depreciate the original roof. Taxpayer also capitalized the cost of the replacement roof and has been depreciating this roof under section 168 since 2000.
- In 2012, Taxpayer wants to file a change in method of accounting to make a late GAA election for the building and its structural components.
- In 2012, Taxpayer also wants to file a change in method of accounting to change from depreciating the original roof to recognizing a loss upon its retirement.

As Rev. Proc. 2012-20 is currently written, it is unclear whether a taxpayer may make both a late GAA election for property placed in service prior to 2012 and also claim a section 481(a) adjustment for a prior disposition of a component of the property on the same Form 3115.

[54] New section 6.32(1)(a)(i) of Rev. Proc. 2011-14.
[55] Based on new section 6.29(4)(a) *Example 1* of Rev. Proc. 2011-14.

Similarly, if there were multiple prior dispositions of components of the property, it is unclear whether the taxpayer may only recognize a loss on some dispositions but not others as part of the same method change and section 481(a) adjustment. The AICPA believes the procedural guidance should clearly indicate which GAA and disposition method changes may be implemented together and pursuant to which automatic change number(s).

b. Provide Examples to Illustrate Method Change Rules

As illustrated in the preceding section, taxpayers must be cognizant of the interrelationships among the various provisions in the temporary regulations, as well as the interrelationships among the various method changes necessary to comply with such regulations. Because of the interrelationship between changes made pursuant to Rev. Proc. 2012-19 and those made pursuant to Rev. Proc. 2012-20, and even changes within the revenue procedures, the AICPA suggests that the government provide examples of how such interrelationships are to be determined for purposes of effectuating the method changes necessary to comply with the temporary regulations.

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We appreciate your consideration of our recommendations, and we welcome further discussion of the comments. If you have any questions, please contact Jane Rohrs, Co-chair, AICPA Repair Regulations Task Force, at (202) 370-2290, or jrohrs@deloitte.com; Natalie Tucker, Co-chair, AICPA Repair Regulations Task Force, at (904) 680-7209, or natalie.tucker@mcgladrey.com; Carol Conjura, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 533-3040, or cconjura@kpmg.com; or Michelle R. Koroghlanian, AICPA Technical Manager, at (202) 434-9268, or mkoroghlanian@aicpa.org.