OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL

FROM: ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: ACCOUNTING METHOD -- RETIREMENTS
CEP

This Field Service Advice responds to your memorandum dated August 18, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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ISSUES:

1. Is taxpayer's method for accounting for retirements a method of accounting, which requires approval to change?
2. Once taxpayer elects the percentage repair allowance (PRA) provision of Treas. Reg. § 1.167(a)-11(d) of the Asset Depreciation Range system ("ADR") pursuant to Internal Revenue Code § 263(f) (redesignated section 263(e)), do the ADR regulations then provide "express provision," as required by section 446(e) for taxpayer to change its consistently applied method of accounting for retirements?
3. Would a change in method of accounting for retirements involve section 481 adjustments?
4. How should taxpayer account for equipment retirements in future years for ADR and non-ADR assets?

CONCLUSION:

1. Yes. A method of retiring assets is a method of accounting and a change in that method requires the consent of the Commissioner under section 446(e).
2. No. The ADR regulations do not provide express provision for taxpayer to change its method of retiring assets.
3. Yes. All prior years, regardless of whether opened or closed, must be adjusted under section 481.
4. For future years, taxpayer must follow the regulations under Treas. Reg. § 1.167-11 and Treas. Reg. § 1.167-8, as applicable, for retirements.

FACTS:

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

The ADR system, also known as the Class Life Asset Depreciation Range system allows taxpayers to elect to apply its provisions to property placed in service after

December 31, 1970 and before January 1,1981. Taxpayer has L, some of which are ADR property and some of which are not.

Starting in Date 3, taxpayer elected under Treas. Reg. § 1.167(a)-11(d)(2)(ii) to use the PRA available under the ADR provisions for the Date 3, Date 4 and Date 5 years for property that had been placed in service between Date 1 and Date 2. Although the election to apply the ADR provisions is no longer in effect, the PRA under the ADR system still remains in effect for expenditures for repair, maintenance, rehabilitation, or improvement of property made after December 31, 1980 for property placed into service during the applicable ADR years.

Under the PRA, a taxpayer may automatically deduct up to a set percentage of all repair expenditures for the year, except for those expenditures considered "excluded additions." Treas. Reg. § 1.167(a)-11(d)(2)(iv).[1] The percentage was intended to reflect the anticipated repair experience of a class of property. Any amount which exceeds the repair allowance must be capitalized.

The last time that taxpayer elected PRA was in Date 2. Since Date 1, taxpayer has consistently accounted for equipment retirements in which all L that were rebuilt were retired to the "scrap" account and gains and losses were reported on their tax returns, using the ICC guidelines. In Dates 3, 4, & 5, however, while the taxpayer retired and claimed a tax loss for non ADR property, on its books the ADR property was retired, but no gain or loss was recognized for tax purposes. The original cost of the rebuilt property had been removed from the supporting detail of the corresponding tax vintage account.[2]

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[1] The PRA is provided for under section 263(f) and is applicable to property placed in service after 1970 and prior to 1981.

Treas. Reg. § 1.263(f)-1(a) prescribes:

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

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

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

Currently this case is in non-docketed status.

LAW AND ANALYSIS

Issues 1 and 2

Accounting Method

The ADR regulations provide specific authority to elect the PRA for each year. Treas. Reg. § 1.167(a)-11(a) &(d)(2)(ii). While it is not challenged that taxpayer may elect the PRA, it is questioned whether its method for accounting for retirements, itself, is a method of accounting, which requires consent to change.

Taxpayer has consistently applied the Interstate Commerce Commission ("ICC") rules for retirement both for book and tax purposes. The ICC rules for retirement provide at rule 2-12 that:

> Rebuilding expenditures are those cost actually incurred which substantially extend the service life or substantially increase the utility of depreciable road and equipment property. The rebuilding expenditures shall be material in nature relative to the current replacement cost of a similar new unit of road or equipment property. . . . [R]ebuilt or converted road or equipment property shall be accounted for as an addition to the appropriate property accounts, **with the old units accounted for as retired from service**.

Under Treas. Reg. § 1.167(a)-11(d)(3) an ADR retirement occurs when–

> [S]uch asset **is permanently withdrawn from use in a trade or business or in the production of income by the taxpayer**. A retirement may occur as a result of a sale or exchange, by other act of the taxpayer amounting to a permanent disposition of an asset, or by physical

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which is eligible property or a group of assets which are eligible property within a single asset guideline class.

> abandonment of an asset. A retirement may also occur by transfer of an asset to supplies or scrap.

[Emphasis added.] A similar provision, Treas. Reg. § 1.167(a)-8(a), applies to non ADR assets.

These two retirement provisions are inconsistent. The ICC rules do not require that an asset be permanently withdrawn from use in a trade or business or in the production of income by the taxpayer to be retired. The taxpayer has consistently followed the ICC rules for both book and tax purposes.

Section 446(e) and Treas. Reg. § 1.446-1(e) provide that a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Treasury Reg. § 1.446-1(e) provides rules for determining what a
method of accounting is, how an adoption of a method of accounting occurs, and how a change in method of accounting may be made.

Under Treas. Reg. § 1.446-1(e)(2)(ii)(a) a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does, or could, change the taxable year in which income is reported, it involves timing and is therefore a method of accounting.

The erroneous treatment of a material item in the same way in determining gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of Treas. Reg. § 1.446-1(e)(2)(ii)(a). See Rev. Rule 90-38, 1990-1 C.B. 57. Taxpayer has consistently treated retirements under the ICC rules for tax purposes. Those rules are inconsistent with the retirement rules under the ADR regulations.

The determination of the PRA deduction depends upon whether the F were retired. See Treas. Reg. § 1.167(a)-11(d)(2)(vi). Thus, taxpayer's treatment of retirements affects the timing of a deduction. Because the treatment of retirements involves the proper time for taking a deduction, it involves a material item. Taxpayer is changing its treatment of retirements from following the ICC rules to following the ADR rules. Such a change in a material item affects the timing of the deduction, for recovering the cost

of the property, although it does not affect the total amount deducted (i.e. lifetime income). Accordingly, the change in the taxpayer's treatment of retirements is a change in a method of accounting. As such, taxpayer is required to secure the consent of the Commissioner prior to changing its method of accounting for retirements, whether or not the method used by taxpayer is proper. Section 446; Treas. Reg. § 1.446-1(e)(2)(i); See also Rev. Rul. 70-165, 1970-1 C.B. 43; Rev. Rul. 70-166; 1970-1 C.B. 45; (Discussing the accounting treatment of retirements under 1.167(a)-8 as a method of accounting under section 446.)

Further, the ADR system does not provide express provision to change taxpayer's method of accounting for retirements. The only express provisions under the ADR system for a change in the method of accounting are for a change in method of depreciation, classification and convention changes. See Treas. Reg. §§ 1.167(a)-11(c)(1)(iii)(a); 1.167(a)-11(f)(1)(i); 1.167(a)-11(b)(4)(iii)(c); 1.167(a)-11(c)(2)(i).

Accordingly, the taxpayer has been using an erroneous method of accounting, and express provision is not provided under the ADR regulations to change its method of retirement.

Issues 3 and 4

Section 481 and Future Accounting Methods

Generally, when a change in method of accounting occurs, the new method of accounting is treated as though it had always been used and not merely used prospectively. See Rev. Proc. 97-27, section 2.05(1), 1997-1 C.B. at 682. Section 481(a) applies and requires taxpayer to take into account those adjustments necessary solely by reason of the method change to prevent the duplication or omission of deductions in any prior taxable year, regardless whether open or closed under the applicable statute of limitations. Hamilton Indus. Inc. v. Commissioner, 97 T.C. 120 (1991); Graff Chevrolet Co. v. Campbell, 343 F.2d 568 (5th Cir. 1965).

As for accounting methods in prospective years, taxpayer must follow the regulations for retirements under the ADR regulations at Treas. Reg. § 1.167(a)-11 for its ADR property, and Treas. Reg. § 1.167(a)-8 for retirements on its non-ADR property. The election of the PRA does not change how the ADR property should be retired. So long as the ADR election was made with respect to the assets, the taxpayer should retire them under the ADR regulations.

Case Development, Hazards, And Other Considerations

Transferral to supplies or scrap is evidence of retirement, yet retirement must be proven, asset by asset, whether the unit or component has been permanently withdrawn from the trade or business of taxpayer or in the production of income of taxpayer.

Even under the ADR definition of retirement, in order to preclude use of the PRA, it must be proven that these repairs constituted "excluded additions" under Treas. Reg. § 1.167(a)-11(d)(2)(vi). To be an excluded addition, the expenditure must be for an additional identifiable unit of property or for a replacement of an identifiable unit of property which has been retired or for replacement of a part in or a component or portion of an existing identifiable unit of property. Further if it is for a replacement of a part in or component or portion of an existing identifiable unit of property, it must be determined whether this was a retirement upon which gain or loss is recognized. Treas. Reg. § 1.167(a)-11(d)(2)(vi)(e).

These determinations would have to be made on an asset by asset basis for all L. [redacted]

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