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Internal Revenue Service
Post Office Box 7604
Ben Franklin Station
Room 5203
Washington, DC 20044
Attn: CC:PA:LPD:PR (REG-168745-03

Re: Comments on proposed regulations under IRC § 263(a)

Dear Sirs/Madam:

On behalf of several clients, we respectfully submit this comment letter in response to the proposed regulations issued by Treasury on August 21, 2006 under IRC § 263(a) (REG-168745-03). The proposed regulations are hereinafter referred to as the "proposed tangibles regulations."

1. Non-incidental materials and supplies, and the 12-month rule

Current Treasury regulations in effect for many years require taxpayers to capitalize amounts paid to acquire property having a useful life substantially beyond the taxable year. Some courts have adopted a 12-month rule for determining whether property has a useful life substantially beyond the taxable year. Under this 12-month rule, a taxpayer may deduct currently an amount paid for property having a useful life that does not extend beyond one year.

In the proposed tangibles regulations, Treasury retained the general rule in the current regulations that taxpayers must capitalize amounts paid to acquire or produce tangible property having a useful life substantially beyond the taxable year. Prop. Reg. § 1.263(a)-2(d)(1)(i). For this purpose, tangible property includes real property (land, buildings and other inherently permanent structures) and tangible personal property as defined in Treas. Reg. § 1.48-1(c) ("any tangible property except land and improvements thereto").

However, the proposed tangibles regulations adopted a 12-month rule which generally permits taxpayers to deduct currently amounts paid to acquire or produce tangible property with an economic useful life of 12 months or less. Prop. Reg. § 1.263(a)-2(d)(4)(i).

On the other hand, the proposed tangibles regulations did not change the tax treatment of materials and supplies under Treas. Reg. § 1.162-3. Prop. Reg. § 1.263(a)-2(c)(2). Thus, non-incidental materials and supplies that are treated as deferred expenses under Treas. Reg. § 1.162-3 may not be currently deducted under the 12-month rule in the proposed tangibles regulations, even though the non-incidental materials and supplies have an economic useful life of 12 months or less.

In this regard, non-incidental materials and supplies appear to be subject to a stricter capitalization rule in the proposed tangibles regulations than expenditures for other types of tangible property.

Taxpayers typically purchase materials and supplies in bulk quantities. Pencils and paper clips are not purchased one by one. Treas. Reg. § 1.162-3 treats the bulk purchase of materials and supplies as a single asset for purposes of determining deductibility. If the bulk purchase of materials and supplies meets the definition of being incidental, the cost of the materials and supplies is deductible upon purchase. Otherwise, the cost of the bulk purchase of materials and supplies is deductible as the materials and supplies are used or consumed by the taxpayer. In effect, the bulk purchase of non-incidental materials and supplies is deducted over the economic useful life of the materials and supplies.

Taxpayers do not make bulk purchases of materials and supplies significantly in advance of when they begin to use or consume the materials and supplies. For that reason, the Service has ruled that materials and supplies used in restaurants and taverns are treated as consumed or used "in the year in which they are received at the restaurant and are available for use." Rev. Proc. 2002-12, 2002-1 C.B. 374, § 5.02.

We do not think there is a good tax policy reason for drawing a distinction between non-incidental materials and supplies, and other tangible property for purposes of capitalization. It is not clear why uniforms, linens and other property with a useful life of one year or less are deductible in full as soon as they are placed in service by the taxpayer, whereas a bulk purchase of non-incidental materials and supplies must be deducted gradually as the materials and supplies are used.

Consider the following example. A calendar year taxpayer purchases uniforms for $100 and places them in service on October 1. The uniforms have a useful life of one year that extends from October 1 to September 30 of the following year. The same taxpayer purchases a six-month supply of ink cartridges on October 1 for $100. The ink cartridges do not meet the narrow definition of incidental materials and supplies.

Under the proposed regulations, the $100 purchase of uniforms is deductible in the first year, whereas only one-half of the ink cartridges are deductible in the first year, even though the uniforms have a *longer* economic useful life to the taxpayer than the bulk purchase of ink cartridges. This result does not make sense from a policy perspective.

The less favorable treatment accorded non-incidental materials and supplies is also contrary to the tax treatment accorded intangible assets. Treas. Reg. § 1.263(a)-4(f) provides that a taxpayer is not required to capitalize amounts paid to create certain intangibles described in subsection (d) if the right or benefit does not extend beyond 12 months after the first date the taxpayer realizes the right or benefit (or, if earlier, the end of the taxable year following the taxable year in which the payment is made).

One of the intangibles described in subsection (d) of Treas. Reg. § 1.263(a)-4 is "prepaid expenses." Thus, an insurance premium for a 12-month insurance policy can be deducted in full upon payment, whereas a bulk purchase of non-incidental materials and supplies that is used by the taxpayer over a shorter period of time can be deducted only gradually under the proposed tangibles regulations. There does not seem to be a good reason for this different treatment.

We would recommend that Treasury and the Service extend the 12-month rule to non-incidental materials and supplies.

2. Exclusivity of the five value factors

The proposed tangibles regulations provide an exclusive list of five factors for determining whether an amount paid to improve property materially increases the value of the property. Prop. Reg. § 1.263(a)-3(e)(1).

Treasury's rationale for the five objective value factors is to move away from a subjective inquiry into the specific facts of each case, which often results in disagreements between taxpayers and the Service. However, application of the five value factors in certain instances will result in capitalization of amounts that would be deductible under current law. Treasury appears to acknowledge this point in the preamble to the proposed tangibles regulations, stating that the five value factors are objective indications of work performed that *generally* would increase the fair market value of property. Thus, there are situations where the five value factors might apply, but the amounts paid would not materially increase the value of the property.

Although the five value factors set forth in the proposed tangibles regulations are an exclusive basis for determining whether there has been a material increase in value of property, the preamble to the proposed regulations also includes the following statement:

> "Whether amounts paid materially increase the value of a unit of property requires an analysis of the purpose, the physical nature, and effect of the work for which the amounts were paid, and not an analysis of the fair market value of the property or the level of monetary expenditures." (emphasis added.)

We would recommend that Treasury minimize the overbreath of the five value capitalization rules as much as possible, consistent with the foregoing statement in the preamble regarding the importance of analyzing the purpose, nature and effect of expenditures.

In this regard, we recommend two specific changes to the five value factors. First, expenditures that otherwise appear to be capital expenditures should be currently deductible if the expenditures are necessary to prevent the useful life of the property from being shortened, and the purpose of the expenditure is to permit the taxpayer to continue to use the property over its original useful life. This principle has been followed in numerous cases, and was summarized by the Tax Court in Munroe Land Co. v. Commissioner, 25 TCM 3 (1966):

> "This Court and other courts have held, upon the particular facts of a case, that expenditures were in the nature of repairs, which ordinarily might be treated as capital expenses, where no increased productivity and no increase in the value and useful life of the property resulted, and where the purpose of the expenditure was to prevent the useful life of the repaired property from being shortened due to unusual circumstances."

There are many court cases that have allowed taxpayers to deduct currently expenditures incurred to prevent a premature shortening of the property's useful life, even though it is clear that these expenditures would trigger one or more of the five value factors set forth in Prop. Reg. § 1.263(a)-3(e)(1). See, e.g., Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103 (1926), acq. V-2 C.B. 2; Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 640-43 (1950); American Bemberg Corp. v. Commissioner, 10 T.C. 361, 376 (1948), aff'd, 177 F.2d 200 (6th Cir. 1949); Oberman Manufacturing Co. v. Commissioner, 47 T.C. 471, 482 (1967), acq. 1967-2 C.B. 3 [the Tax Court stated that "it is necessary to take into consideration the purpose for which an expenditure is made in order to determine whether such expenditure is capital in nature or constitutes a current expense;" the expenditures in this case were repairs even though "the work included some structural change, namely, the insertion of an expansion joint in the roof"].

The proposed tangibles regulations should be amended to reflect this case law.

Second, Treasury indicates in the preamble to the proposed tangibles regulations that amounts paid to make substantial improvements to property may not always increase the fair market value of the property, or may not increase the fair market value of the property by the full amount paid for the improvements. We agree with the court's holding in Harrah's Club v. United States, 661 F.2d 203 (Ct. Cl. 1981) that excessive automobile restoration costs should be capitalized.

However, there are situations where the courts and the Service have held that amounts paid in excess of any value produced are deductible expenditures. Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805 (6th Cir. 1948) (amount paid to purchase the fee interest in land in excess of its value was deductible as an expense of escaping a burdensome lease); Rev. Rul. 79-66, 1979-1 C.B. 114 (expenditures to improve a residence in excess of the increase in value to the residence are deductible as medical expenses); Treas. Reg. § 1.213-1(e)(1)(iii) ("a capital expenditure for permanent improvement or betterment of property which would not ordinarily be for the purpose of

medical care (within the meaning of this paragraph) may, nevertheless, qualify as a medical expense to the extent that the expenditure exceeds the increase in the value of the related property").

In light of these authorities -- which look to the purpose, nature and effect of an expenditure in determining whether the expenditure is deductible or capital -- we would recommend that the five value factors be revised to recognize that an expenditure which improves property may be deductible if the primary purpose or substance of the expenditure is for something that is deductible. For example, expenditures whose purpose is to eliminate a safety hazard or future litigation risk should be deductible even though the expenditure improves property, if the value of the property is not materially increased by the expenditure.

In those situations, taxpayers should be permitted to show by appraisal or other proof that the expenditure in question did not materially increase the value of the property, substantially prolong its useful life, or adapt the property to a new or different use.

In theory, it might seem that an expenditure which eliminates a safety hazard or litigation risk would make the improved property more valuable. However, in practice, the cost of complying with safety and environmental laws in many cases far exceeds any economic benefit to the property. An expenditure that nominally "improves" property, but does not materially increase the value of the property or substantially prolong its useful life, should not be a capital expenditure.

Thank you for your consideration of these comments.

Very truly yours,

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cc: Ms. Sharon Kay, Tax Legislative Counsel
Ms. Kimberly L. Koch, Internal Revenue Service