Request for Comments Concerning the Application of Sections 162 and 263 to Tangible Property

Notice 2004–6

The Internal Revenue Service and Treasury Department intend to propose regulations that clarify the application of §§ 162 and 263 of the Internal Revenue Code to expenditures paid or incurred to repair, improve, or rehabilitate tangible property. This notice identifies issues the Service and Treasury Department may address in the regulations. The Service and Treasury Department want to provide clear, consistent and administrable rules that will reduce the uncertainty and controversy in this area, while also preventing the distortion of income. Accordingly, the Service and Treasury Department request public comments on whether these or other issues should be addressed in the regulations and, if so, what specific rules and principles should be provided.

ISSUES ON WHICH COMMENTS ARE REQUESTED

1. **What general principles of capitalization should apply to expenditures to repair or improve tangible property?** The regulations currently require capitalization for expenditures that materially increase the value of property, substantially prolong the useful life of property, or adapt property to a new or different use. Sections 1.162–4; 1.263(a)–1(b) of the Income Tax Regulations. Are these the appropriate tests for capitalization? If so, how should the forthcoming guidance clarify the application of these standards? Alternatively, should different standards apply? If so, what different standards?

2. **In applying the general principles, what is the appropriate "unit of property"?** Should any of the following factors be determinative or relevant in analyzing what is the appropriate unit of property: (1) whether the property is manufactured, marketed, or purchased separately; (2) whether the property is treated as a separate unit by a regulatory agency, in industry practice, or by the taxpayer in its books and records; (3) whether the property is designed to be easily removed from a larger assembly, is regularly or periodically replaced, or is one of a fungible set of interchangeable or rotable assets; (4) whether the property must be removed from a larger assembly to be fixed or improved; (5) whether the property has a different economic life than the larger assembly; (6) whether the property is subject to a separate warranty; (7) whether the property serves a discrete purpose or functions independently from a larger assembly; or (8) whether the property serves a dual purpose function, (*e.g.*, inventory)? *See Smith v. Commissioner*, 300 F.3d 1023 (9th Cir. 2002); *Hawaiian Indep. Ref. Inc. v. United States*, 697 F.2d 1063 (Fed. Cir. 1983), *cert. denied*, 464 U.S. 816 (1983); *Electric Energy, Inc. v. United States*, 13 Cl. Ct. 644 (1987); *FedEx Corp. v. United States*, No. 01–2200 (W.D. Tenn. August 28, 2003); *Ingram Indus., Inc. v. Commissioner*, T.C.M. 2000–323; *LaSalle Trucking Co. v. Commissioner*, T.C.M. 1963–274. Are there other facts or circumstances that should be taken into account?

3. **In determining whether an expenditure materially increases the value of property or substantially prolongs the useful life of property, what is the proper starting point for comparison?** Should the forthcoming guidance adopt the test in *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), *nonacq*. 1964–2 C.B. 8, which looks at "whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure"? Should the starting point be different depending on whether the expenditure was necessitated by a single event, such as a casualty, or from gradual wear and tear? *See Ingram Indus*.; Rev. Rul. 2001–4, 2001–1 C.B. 295. If the expenditure relates to a component part, does the relative importance of the component part to the functionality of the underlying asset affect the starting point? *See Smith*, 300 F.3d at 1031–32. Should the test in *Plainfield-Union* apply as well to expenditures incurred upon acquisition of the property and, if so, how would the test apply?

4. **What is "value" for purposes of the "material increase in value" rule?** Does "value" refer solely to the fair market value of the property? Alternatively, should any "enhanced functionality" of the property in the taxpayer's business (*e.g.*, an enhancement to capacity, productivity, quality, or efficiency) be treated as an additional basis for capitalization? *See Vanalco, Inc. v. Commissioner*, T.C.M. 1999–265, *aff'd sub nom.*, *Smith v. Commissioner*, 300 F.3d 1023 (9th Cir. 2001).

5. **How should it be determined whether there has been a "material increase" in value?** Should an increase in the fair market value of property after the expenditure be compared to the fair market value of the property before the expenditure or the cost of equivalent new property? Should the regulations create a presumption that an addition to fair market value is material (or immaterial) if it exceeds (or is less than) a certain percentage of the fair market value of the property or the cost of equivalent new property?

If enhanced functionality constitutes a basis for requiring capitalization, should the regulations require a certain percentage of improvement before the expenditures are required to be capitalized (*e.g.*, an X% increase in capacity, productivity, or efficiency)? If the enhanced functionality cannot be measured by a percentage of improvement (*e.g.*, enhancements to safety) how should a "material increase" be determined?

6. **What is "useful life" for purposes of the "substantially prolongs useful life" rule?** Is "useful life" the period the taxpayer may reasonably expect to use the property in its trade or business (*see* § 1.167(a)–1(b)) or the period of use inherent in the property? Should the following factors be considered in determining a property's useful life: (1) wear and tear or decay and decline from natural causes; (2) normal progress of art, economic changes, inventions, and current developments within the industry or the taxpayer's trade or business; (3) climatic and other local conditions specific to the taxpayer's trade or business; (4) the taxpayer's policy as to repairs, renewals, and replacements; and (5) whether the asset was subject to unusual wear and tear, for example, heavy

or extraordinary use. *See* § 1.167(a)–1(b). Should the recovery periods under § 168 be relevant to the determination of "useful life" for capitalization purposes?

7. **How should it be determined whether an expenditure "substantially prolongs" the useful life of the property?** If the expenditure prolongs the useful life of property for a fixed number of years is that sufficient to require capitalization? Alternatively, does the expenditure need to prolong the property's initial or remaining useful life by a relative amount (*e.g.*, by a certain percentage)? Should the test be whether the expenditure essentially results in a rebuilding? *See Ingram Indus.*; *Vanalco*. Is it relevant at what point in the useful life of the property the expenditure is incurred? Are there presumptions or safe harbors that would be useful, for example, a presumption that an expenditure that prolongs the useful life of the property for less than *X* months or by less than *Y%* is not "substantial"?

8. **Is § 263(a)(2) a different test from the "substantially prolongs the useful life of the property" test?** If so, what rules should be provided for determining whether an expenditure "restores property or makes good the exhaustion thereof for which an allowance is or has been made" within the meaning of § 263(a)(2)?

9. **What factors are relevant in determining whether an expenditure adapts property to a new or different use?**

10. **What other factors should be considered in determining whether an expenditure must be capitalized?** For example, should the following factors affect the analysis of whether an expenditure increases the value of property, prolongs the useful life, or adapts the property to a new or different use and, if so, how: (1) the nature and extent of the work performed (*e.g.*, the time and effort required to perform the work, whether the property had to be taken out of service for the work, and the portion of the property affected by the work); (2) the use of materials that reflect product enhancements, improved materials, or technological improvements; (3) the existence of regulatory mandates; (4) the frequency of the expenditure (*e.g.*, whether the expenditure is incurred once or every couple of years); (5) the taxpayer's knowledge of pre-existing defects at the time the property was acquired; (6) whether a substantial percentage of the parts of the property or large or significant parts of the property are replaced; (7) whether the property was functioning immediately before the expenditure; (8) the absolute or relative amount of the expenditure; (9) the relative importance of a component and the "essential functional nature" of a component (*see Smith*, 300 F.3d at 1031–32); and (10) whether the expenditure is for an activity described in a manufacturer's suggested maintenance program?

11. **Should the regulations provide "repair allowance" type rules?** For example, should the regulations provide rules similar to the percentage repair allowance system, since repealed, that is described in § 1.167(a)–11(d)(2)? If so, should the allowance be an annual amount based on a percentage of the unadjusted basis of the asset or should the allowance be an annual amount based on gross receipts or net income? Should a repair allowance be structured as a safe harbor? Should a safe harbor apply to both personal property and real property? *See Alacare Home Health Serv. Inc. v. Commissioner*, T.C.M. 2001–149.

12. **Should the regulations provide a *de minimis* rule?** If so, what should the *de minimis* amount be (*e.g.*, a fixed amount, a percentage of the fair market value of the property, a percentage of the unadjusted or adjusted basis of the property, or a percentage of the cost of equivalent new property)? Should a *de minimis* rule be structured as a safe harbor? Should a *de minimis* rule apply to both personal property and real property? Should the *de minimis* amount be periodically increased (or decreased), and if so, how? *See Cincinnati, New Orleans and Texas Pac. Ry. Co. v. United States*, 424 F.2d 563 (Ct. Cl. 1970); *Alacare*.

13. **What facts are relevant in determining whether a repair must be capitalized under the "plan of rehabilitation" doctrine?** Should the regulations adopt a facts and circumstances analysis that looks to the purpose, nature, extent, and value of the work done? *See United States v. Wehrli*, 400 F.2d 686 (10th Cir. 1968). What connection is required between the repairs and the capital improvements for the plan of rehabilitation doctrine to apply? That is, must repairs be incident to, integral to, contemporaneous with, or because of the capital improvements? How extensive do the capital improvements have to be to result in a plan of rehabilitation (*e.g.*, is at least one capital expenditure required before the doctrine applies and may a single capital expenditure cause the doctrine to apply)? Are repairs part of a plan of rehabilitation when the repairs are done in preparation for or as part of a remodeling project? *See Norwest Corp. v. Commissioner*, 108 T.C. 265 (1997). If so, what constitutes a remodeling project? Does the doctrine apply if the work is part of a continuous or ongoing process of replacing an asset over time (*e.g.*, if normal operation requires ongoing repainting and repapering, do repainting and repapering costs become capital if they correspond with a capital remodeling project)? *See Moss v. Commissioner*, 831 F.2d 833 (9th Cir. 1987). Should the regulations establish a bright-line test that repairs of property are considered part of a plan of rehabilitation if the property is, at the time the repairs are made, not suitable for its intended use, in a general state of disrepair, or at the end of its useful life? Should the regulations address other issues, such as whether a written plan is required and whether the existence of a written plan indicates a plan of rehabilitation?

14. **Should the regulations provide specific rules for any particular type or category of expenditure?**

15. **Are there any situations in which the tax treatment of an expenditure to repair, improve, or rehabilitate tangible property should follow the financial or regulatory accounting treatment for that expenditure?**

DATES: Written and electronic comments must be submitted by March 1, 2004.

ADDRESSES: Send submissions to: CC:PA:LDP:PR (Notice 2004–6), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:ITA:PR (Notice 2004–6), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Alternatively, taxpayers may send submissions electronically directly to the Service at: *Notice.comments@irscounsel.treas.gov* All materials submitted will be available for public inspection and copying.

FOR FURTHER INFORMATION CONTACT: Concerning submissions, Guy Traynor (202) 622–7180; concerning this notice, Grace K. Matuszeski (202) 622–7327 (not toll-free numbers).