RETAIL INDUSTRY LEADERS ASSOCIATION
Educate. Innovate. Advocate.

1700 NORTH MOORE STREET
SUITE 2250
ARLINGTON, VA 22209
T (703) 841-2300 F (703) 841-1184
WWW.RILA.ORG

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BY ELECTRONIC SUBMISSION

Ms. Emily S. McMahon
Acting Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Guidance Regarding Deduction and Capitalization of Expenditures Relating to Tangible Property – IRS REG–168745–03

Dear Acting Assistant Secretary McMahon and Chief Counsel Wilkins:

On behalf of the Retail Industry Leaders Association (RILA), I respectfully submit comments on the temporary and proposed regulations published by the Department of the Treasury (Treasury Department) and the Internal Revenue Service (Service) on December 27, 2011, regarding deduction and capitalization of expenditures relating to tangible personal property (herein referred to as the "Temporary Regulations").[1]

By way of background, RILA is the trade association of the world's largest and most innovative retail companies. RILA members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than $1.5 trillion in annual sales, millions of American jobs and more than 100,000 stores, manufacturing facilities and distribution centers domestically and abroad.

RILA welcomes the opportunity to comment on the Temporary Regulations and appreciates the Treasury Department's and the Service's consideration of the detailed comments provided below. This letter focuses primarily on the provisions of the Temporary Regulations pertaining to §§ 162(a), 168, and 263(a)[2] and addresses the initial concerns of RILA's member companies. Given the short time that the Temporary Regulations have been available and the limited experience that retailers have had applying their complex and far-reaching requirements, additional issues may be identified. Accordingly, we urge the Treasury Department and the Service to extend the comment period to give RILA members and other taxpayers sufficient time to assess the impact of the new rules and provide the necessary feedback. RILA will submit as

[1] T.D. 9564, RIN 1545-BJ93, 76 Fed. Reg. 81060 (Dec. 27, 2011); RIN 1545–BE18, 76 Fed. Reg. 81128 (Dec. 27, 2011).

[2] Unless otherwise specified, all "§" references are to the Internal Revenue Code of 1986 and all "Treas. Reg. §" references are to the Treasury Regulations, final and temporary, promulgated there under, both as amended through the date of this letter.

quickly as possible any additional issues that our members identify and ask that they be considered as the Temporary Regulations are finalized.

Section I of this letter explains RILA's general concerns about the extent to which the Temporary Regulations further the goals of simplicity and certainty; Section II addresses issues relating to the unit-of-property definition, primarily with respect to the disparate treatment of buildings and structural components; Section III stresses the need for a clear materiality standard to reduce uncertainty under the new rules; Section IV sets out the reasons for allowing buildings to qualify for the routine-maintenance safe harbor; Section V discusses the need for additional guidance with respect to "refresh" expenditures, and the "new or different use" rule; Section VI examines the challenges posed by the new rules regarding the disposition of building components; Section VII notes concerns about the de minimis rule/capitalization threshold; and Section VIII highlights the need for additional guidance on transitional issues and **recommends an election that would permit taxpayers to apply the Temporary Regulations for either their first or second taxable year beginning on or after January 1, 2012.**

Overall, we are concerned that if significant changes are not made in the final regulations, or sooner through additional guidance, the treatment of expenditures relating to tangible personal property will perpetuate excessive compliance costs for both taxpayers and the Service and ultimately lead to significant controversies. With the economic challenges facing business taxpayers and the fiscal constraints confronting the government, these regulations represent a prime opportunity to benefit all parties through simplification, reduced burden, improved compliance, and fewer disputes.

I. General Concerns

RILA appreciates that almost a decade has been dedicated to proposed regulations, public comments, and work by the Treasury Department and the Service to develop the Temporary Regulations. RILA and its members have long anticipated this guidance and hoped that it would provide clear, consistent, simplified rules that would give taxpayers a greater degree of certainty regarding the treatment of expenditures relating to tangible property.[3] We are concerned, however, that certain significant aspects of the Temporary Regulations do not achieve that objective.

At a fundamental level, the objective of the Temporary Regulations should be to clarify, but not change, long-standing law on the deduction versus capitalization of expenditures made with respect to tangible property. For more than 80 years, the distinction between deductible repairs and capital improvements has consistently been described as set forth in *Illinois Merchants Trust Co., Executor of Estate of Manierre v. Commissioner*:

[3] The Preamble to the Temporary Regulations notes that "A goal of both the 2006 and 2008 proposed regulations was to reduce controversy and provide clarity in determining whether an amount is paid for an improvement that must be capitalized under section 263(a)." 76 Fed. Reg. at 81065. We presume that that goal was also a priority in the development of the Temporary Regulations and that it will continue through the process of finalizing the regulations.

> In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.[4]

The Temporary Regulations, however, make a dramatic shift. Instead of the balanced approach of permitting taxpayers to deduct ordinary and necessary expenses that do not materially increase the value or prolong the life of the property or adapt it to a new or different use under § 162 and capitalizing those that do under §263(a),[5] the new rules implicitly presume that any such expenses must be capitalized unless proven otherwise.[6] The rationale for such a dramatic departure from long-standing judicial and regulatory precedents, which have survived multiple reenactments of the Internal Revenue Code, is unclear.

For retailers, the inconsistency of the Temporary Regulations creates not only uncertainty, but significant new administrative burdens as decades of recordkeeping and substantiation practices are upended. Moreover, while it has long been recognized that the deduction versus capitalization issue is inherently factual,[7] the Temporary Regulations miss a significant opportunity to simplify rules that apply to virtually every taxpayer in every industry through clear tests and objective standards. Instead, the new rules continue to rely heavily on facts-and-circumstances determinations as well as subjective terms to effectuate the particular rules, which simply foster uncertainty and fuel audit controversies regarding these issues.

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[4] 4 B.T.A. 103, 106 (1926), *acq.*, V-2 C.B. 2.

[5] Prior to the new rules, Treas. Reg. § 1.162-4, implementing § 162, provided, in pertinent part: "The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition, may be deducted as an expense." Correspondingly, the previous version of Treas. Reg. § 1.263(a)-1(b), implementing § 263(a), restated the same rule but from the perspective of the capitalization requirements. Accordingly, expenditures were capital if they: "(1) . . . add to the value, or substantially prolong the useful life, of property owned by the taxpayer . . . or (2) . . . adapt property to a new or different use."

[6] Treas. Reg. § 1.162-4T now provides that, "A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized." In contrast, Treas. Reg. § 1.263(a)-1T now states that, "no deduction is allowed for – (1) Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or (2) Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."

[7] *See United Dairy Farmers, Inc. v. U.S.*, 267 F.3d 510, 519 (6th Cir. 2001); *Libby & Blouin, Ltd. v. Comm'r,* 4 B.T.A. 910, 913 (B.T.A. 1926); Rev. Rul. 2001-4, 2001-1 C.B. 295.

II. Unit of property

A significant concern for retailers generally is the inconsistent treatment under the Temporary Regulations of buildings from that of other types of tangible property. Next to consumers and the goods and services retailers offer, the singular characterizing feature of a retail business is the facility from which the retailer interacts with the consumer – e.g., storefronts, showrooms, department stores. As discussed in greater detail below, we believe the adverse treatment under the Temporary Regulations of retail buildings, and the functionally integrated systems and components of which they are comprised, is inappropriate and inconsistent with long-standing case law as well as inconsistent with the treatment of other complex property within the Temporary Regulations themselves. For RILA's members alone, these requirements will apply to more than 100,000 stores and other facilities in every state and internationally in some cases.

a. Regulations depart from the long-standing interpretation of unit of property in the case law and other precedents

In general, the new rules appropriately retain the "functional interdependence" standard from the 2008 Proposed Regulations[8] to determine the unit of property. Treas. Reg. § 1.263(a)-3T(e)(1). This standard derives from *Fedex Corporation v. United States*, the seminal case determining the unit of property in the context of the deductibility versus capitalization of repairs.[9] In that case, the Sixth Circuit held that the aircraft engine was not a separate unit of property, but rather the entire aircraft was the appropriate unit of property for purposes of determining whether the engine overhaul costs were deductible despite the engine being disassembled from the rest of the aircraft while the lengthy overhaul work was being performed and the likelihood that the overhauled engine would not even be placed on the same airframe after the work was performed. *See also Ingram Indus., Inc. v. Comm'r*, T.C. Memo 2000-323 (towboat engine not treated as separate from the overall boat for purposes of determining deductibility of periodic, significant engine maintenance); Rev. Rul. 2001-4, 2001-1 C.B. at 298-99 (holding in Situation 1 that extensive heavy maintenance of an aircraft airframe is deductible despite pervasive effects on the airframe's parts and components).

Surprisingly, and contrary to the well-reasoned opinions in *Fedex* and *Ingram Industries*, the Temporary Regulations carve out a unique and disparate exception to the functional-interdependence standard – one that is applicable only to buildings. Treas. Reg. § 1.263(a)-3T(e)(2)(ii). Under this exception, the analysis of whether an expenditure is deductible or capitalized turns not on the unit of property (i.e., the building), but rather on its "building systems," which are comprised of eight enumerated structural components of a building under the Temporary Regulations.[10] Treas. Reg. § 1.263(a)-3T(e)(2)(ii)(B)(1) – (8).

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[8] REG-168745-03, 73 Fed. Reg. 46 (Mar. 10, 2008).
[9] 291 F. Supp.2d 699 (W.D. Tenn. 2003), *aff'd* 412 F.3d 617 (6th Cir. 2005).
[10] Adding to the uncertainty and complexity of this unique treatment, the Temporary Regulations reserve a ninth category for additional components to be identified in the future. Treas. Reg. § 1.263(a)-3T(e)(2)(ii)(B)(9).

The inherent contradiction of this special treatment for buildings is difficult to understand. How can the building be the unit of property but not be determinative in and of itself of whether a repair or remodeling expense is deductible or requires capitalization? Moreover, how can a building's structural components – its plumbing or electrical systems, roof, heating, ventilation and air conditioning (HVAC) system – be anything but functionally interdependent with the building itself? The court's opinion in *Fedex* illustrates the inconsistency resulting from the Temporary Regulations:

> A tugboat cannot tow barges without its engines, and the engines cannot tow barges without a tugboat. . . . Engines and [auxiliary power units] cannot perform their function of powering jet aircraft unless they are mounted on those aircraft in proper working order.[11]

Applying the court's logic to a building, the pipes and fixtures cannot perform their function of supplying water and removing waste and the wiring cannot supply power unless they are each installed in the walls, floors and ceilings of the building structure. Similarly, a building cannot maintain the necessary temperature environment without an HVAC system, and the HVAC units would have nothing to heat or cool without being installed in the building structure.

The only rationale offered for the unique, adverse treatment of buildings under the Temporary Regulations is the statement in the Preamble that the new approach "produces results that are more consistent with current law."[12] The examples of "current law" provided in the Preamble, however, include cases that all predate the *Fedex* decision and its well-reasoned approach to determining the unit of property. The application of the unit-of-property concept in these cases was based on little or no analysis of the issue or its application to the deductibility or capitalization of expenditures relating to the unit of property, and these cases were frequently conclusory, inconsistent and results-driven.

Without a clear justification in law or policy, we submit that a building ***and*** its structural components are a single unit of property, consistent with the reasoning in *Fedex*. Accordingly, the new rules regarding repairs of tangible property should be applied to the entire building, without separate componentization of its systems, just as they are applied to other complex assets like aircraft and boats.

b. The building unit-of-property approach is inconsistent with the Temporary Regulations' treatment of other tangible assets

The building exclusion under the Temporary Regulations is inconsistent with the treatment of other complex tangible property, like aircraft and tugboats, which are treated as a single unit of property under the new rules. *See* Treas. Reg. § 1.263(a)-3T(g)(5) Ex. 1 (aircraft) and Ex. 8 (towboats). In many respects, a commercial aircraft is analogous to a retail storefront. Each has an HVAC system, a plumbing system, electrical system, fire-protection and alarm system, security system, and even a gas distribution system to a varying extent. Nevertheless, despite

[11] 291 F. Supp.2d at 712.
[12] Preamble, 76 Fed. Reg. at 81066.

having such complex, functionally interdependent component systems, owners of aircraft are not required under the Temporary Regulations to account for expenditures to maintain or improve the aircraft based on its structural components, while owners of buildings must undertake such burdensome new requirements.

Moreover, the componentization of a building creates an inconsistency with the depreciation rules. Since the enactment of the Accelerated Cost Recovery System in 1981, taxpayers generally have been barred from componentizing a building for depreciation purposes.[13] As a result, retailers stand to be whip-sawed under the Temporary Regulations because they will be required to componentize a building to their detriment with respect to capitalization of certain expenses, while they are precluded from depreciating such capitalized amounts on a component-by-component basis. If the componentization approach is retained, which we do not support, it would only be equitable for the Treasury Department and the Service to reassess the deprecation rules to eliminate the whip-saw potential and permit taxpayers to utilize the appropriate recovery period for the component property.

In short, consistent treatment of tangible property within the regulations is not only sound tax policy, but also holds all industries to the same standard. As noted above, retailers depend significantly on real property in their business models and already face a significant impact between the current deduction of a repair expense versus having to depreciate it over a 39-year recovery period (or the temporary 15-year period for leasehold and certain retail improvements). The tax regulations should not create further disadvantages that adversely affect one industry over another.

c. Componentization will lead to enormous administrative burdens and foster audit controversy

The result of the Temporary Regulation's disparate treatment of buildings from other types of tangible property will be substantial uncertainty and onerous new recordkeeping burdens. Even on a prospective basis for a building acquired this year, tracking costs on a component basis under the new rules will require significant system changes and time to implement, because most existing property accounting systems are not designed to track the new eight categories enumerated in the Temporary Regulations. Moreover, appraisals and other valuation methods will be needed to establish the individual value of the building structure as well as its structural components, which are not separately identified in a typical real estate transaction.

For existing buildings, the recordkeeping burden becomes even more complex. Large retailers may have thousands of storefronts and other facilities across the nation with non-uniform structures, each subject to varying building codes and other state and local requirements. Because there has never been a requirement for tax, financial statement, or other business purposes to assign a cost basis or depreciation to each of the enumerated structural components

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[13] *See* former § 168(f), added by the Economic Tax Recovery Act of 1981, Pub. L. No. 97-34; *see also AmeriSouth XXXII, Ltd. v. Comm'r*, T.C. Memo 2012-67 (Mar. 12, 2012) (citing to Rev. Proc. 87-56, 1987-2 C.B. 674 and Treas. Reg. § 1.48-1(e) for definition of buildings and structural components; holding that structural components are depreciated over the life of the residential real property).

separate from the building itself, most retailers do not have records to do so. Moreover, many accounting systems do not allow for acquisition or disposal of a sub-asset – let alone the broad categories of structural components under the Temporary Regulations. As a result, taxpayers will have to implement costly new systems, or worse, make manual entries, simply to maintain the records needed to comply with the new regulations once the basis and age of such systems are established.

To eliminate this inconsistency, simplify the Temporary Regulations, and reduce the recordkeeping burdens and resulting controversies, RILA strongly recommends that the Treasury Department and the Service eliminate the unique adverse treatment of buildings under the unit-of-property definition and treat buildings and their functionally integrated structural components as a single unit of property in the same manner as other types of complex tangible property illustrated in the Temporary Regulations.

d. Alternative: Exclude non-material building components

The Temporary Regulations also treat each of the eight enumerated structural components of a building as having equal significance such that any expenditure determined to be a betterment with respect to a particular component will result in a betterment of the entire building and require capitalization of the associated costs. Treas. Reg. § 1.263(a)-3T(h)(2). The relevance of a particular building component is likely to vary significantly for different types of taxpayers, even within the retail industry. For example, a grocery store may have more significant plumbing systems for kitchen and bakery facilities, while a clothing store may only have a single set of restrooms. Similarly, the fire-protection system may have a significantly lower cost than the HVAC system as a percentage of the overall building cost.

If our foregoing recommendation to eliminate the componentization of a building under the Temporary Regulations is not accepted after appropriate consideration, then we urge the Treasury Department and the Service to modify the new rules to provide that a building component must be separately recognized only if it meets a materiality threshold with respect to the overall building. For example, a building with a cost of $1 million dollars should not have to recognize as a separate building component a fire-prevention system with a cost of $25,000. Limiting the componentization of a building only to its material structural components would help reduce the compliance and recordkeeping burdens under the Treasury Regulations.

III. Materiality standard

Whether applied to a building as a single unit of property or to its enumerated structural components, the Temporary Regulations require that an expenditure made to maintain or improve the property be evaluated in terms of the materiality of its effect. For example, the Temporary Regulations provide that an amount paid will result in a betterment of a unit of property only if it:

- Ameliorates a *material* condition or defect in the unit of property,
- Results in a *material* addition to the unit of property, or

- Results in a *material* increase in capacity, productivity, strength, or quality of the property.

Treas. Reg. § 1.263(a)-3T(h)(1)(i) – (iii). Nevertheless, the Temporary Regulations do not provide a definition of the term "material" nor a bright-line test or other guidance as to what the Service will consider to be material.

The vagaries of materiality are also reflected in the examples to the betterment provisions of the Temporary Regulations. For instance, Example 1 concludes that contaminated soil remediation results in an amelioration of a material defect, thereby constituting a betterment and requiring capitalization of the remediation costs. Treas. Reg. § 1.263(a)-3T(h)(4) Ex. 1. In contrast, Example 2 concludes that removal of asbestos from a building does not correct a material defect of a pre-existing condition, permitting the remediation costs to be currently deducted. Neither example quantifies the expenditures made to correct the condition nor provides any other objective data on which to evaluate the materiality of the defect and distinguish between the two conclusions. Treas. Reg. § 1.263(a)-3T(h)(4) Ex. 2.

Moreover, Example 7 under the betterment rules provides a retail-specific case in which the taxpayer's replacement of the bathroom fixtures (i.e., toilets, sinks and plumbing fixtures) is determined to be a betterment, requiring capitalization of the direct and indirect costs. Treas. Reg. § 1.263(a)-3T(h)(4) Ex. 7. This example fails to require even a threshold determination of materiality and begs the question: how can 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? With respect to retail buildings in particular, bathrooms are insignificant elements of both the building unit of property *and* the plumbing-system structural component. Even a complete remodel of a bathroom should be an immaterial repair, both in terms of its cost (e.g., $30,000) and the fact that such costs merely keep the bathroom in a useable condition for customers.

Given that materiality is inherently subjective and will likely lead to protracted controversies between taxpayers and the Service, we strongly urge the Treasury Department and Service to adopt an objective materiality standard. While we recognize that the 50-percent threshold included in the 2008 proposed regulations was not retained in the Temporary Regulations,[14] a lesser percentage or range could be established, with expenditures above such percentage, or within such range, creating a rebuttable presumption that they are material, thereby constituting a betterment requiring capitalization of the amounts expended.

The betterment provisions of the Temporary Regulations already provide limited illustrations of such a standard. For instance, Example 18 describes harbor dredging undertaken to increase the depth of a channel from 18 feet to its original 20-foot depth – an 11-percent increase – which is held not to result in a material increase. Treas. Reg. § 1.263(a)-3T(h)(4) Ex. 18. In contrast, Example 17 finds that dredging, which results in a 50-percent increase in channel depth, is material and requires capitalization of the dredging expenses. *See also* Treas. Reg. § 1.263(a)-

[14] Preamble, 76 Fed. Reg. at 81065.

3T(h)(4) Ex. 16 (holding that a 50-percent increase in the load-carrying capacity of the building structure is material).

Similarly, the Temporary Regulations' restoration provisions also include a number of examples that provide analogous thresholds that would be consistent with a general materiality standard. For example, to determine whether an expenditure constitutes a replacement, Treas. Reg. § 1.263(a)-3T(i)(4) looks to whether the affected major component or structural part comprises "a large portion of a physical structure" – in effect, whether it is material. The examples imply a number of thresholds: In Example 17, two out of ten HVAC units are found not to "comprise a large portion of the physical structure of the HVAC system," suggesting a 20-percent threshold for replacement of HVAC equipment without constituting a restoration. Treas. Reg. § 1.263(a)-3T(i)(5) Ex. 17. Example 21 concludes that the replacement of three out of 20 sinks – 15 percent – in a retail building does not comprise a large (i.e., material) portion of the physical structure. Similarly, Example 23 concludes that the replacement of 30 out of 300 exterior windows does not comprise a large portion of the physical structure, while Example 24 finds that replacement of 200 out of 300 windows, or 67 percent, is material.[15]

Without an objective standard, taxpayers will be left to their best efforts to divine what the Service will find to be material for each and every expenditure made to repair or maintain a building or any of the enumerated structural components. The result will inevitably be divergent results between taxpayers and perpetual controversy between taxpayers and the Service, neither of which furthers the goal of simplifying the tax rules, increasing certainty, or improving compliance.

IV. Routine maintenance safe harbor

In keeping with RILA's recommendation that buildings be treated consistently under the unit-of-property rules, we also believe buildings should qualify for the routine-maintenance safe harbor under the new rules. Treas. Reg. § 1.263(a)-3T(g). The Temporary Regulations define "routine maintenance" as "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 ordinary efficient operating condition." Treas. Reg. § 1.263(a)-3T(g)(1). To qualify for the safe harbor, the taxpayer must reasonably expect to perform such maintenance more than once during the class life of the unit of property. *Id.* Notwithstanding the fact buildings have ongoing maintenance requirements that squarely fit within the foregoing definition and are expected to occur more than once during the building's class life, the Temporary Regulations summarily exclude buildings, as well as their structural components, from the safe harbor, requiring instead a facts-and-circumstances analysis with respect to each and every maintenance expenditure. *Id.*

As noted above, buildings are fundamentally analogous to aircraft in terms of the functional integration of their structural components, and both clearly have regular routine maintenance requirement expected to occur more than once during their long class lives. Nevertheless, as illustrated by Example 1 in the safe-harbor rules, an aircraft's continuous maintenance program –

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[15] *See also* Rev. Proc. 2011–43, 2011–37 I.R.B. 326 (establishing a 10-percent safe harbor method for electric utility transmission and distribution property).

which can entail extensive disassembly of the airframe and engines, inspections, and replacement of certain parts – constitutes routine maintenance, while similar, and potentially less extensive, periodic maintenance at a retail store is excluded from the safe harbor. Treas. Reg. § 1.263(a)-3T(g)(5) Ex. 1; *compare* Rev. Rul. 2001-4, 2001-1 C.B. at 296 (heavy airframe maintenance in Situation 1 includes disassembly and repairs to galleys and lavatories, with expenses held to be deductible), *with* Treas. Reg. § 1.263(a)-3T(h)(4) Ex. 7 (replacement of bathroom fixtures in a retail store are required to be capitalized).

Similarly, the routine-maintenance safe-harbor applies to towboats, another complex property with numerous structural components and a long class life. As illustrated by Example 8, the taxpayer is permitted to deduct regular maintenance applied to the towboat's two diesel engines because the maintenance is necessary to keep the engines in ordinary efficient operating condition and such upkeep is expected to be conducted more than once during the 18-year class life of the towboat. Treas. Reg. § 1.263(a)-3T(g)(5) Ex. 8; *see also* Treas. Reg. § 1.263(a)-3T(g)(5) Ex. 7 (suggesting that regular maintenance activities on railroad freight cars would qualify for the routine-maintenance safe harbor if they occurred more than once during the 14-year class life of the property).

Given the clear analogies between retail buildings and other complex property, especially aircraft, we see no apparent policy reason to permit aircraft, towboats, and freight cars to qualify for the routine-maintenance safe harbor, and the current deduction of routine maintenance expenses, while arbitrarily excluding buildings.

The Preamble to the Temporary Regulations provides that "[b]ecause buildings typically have a long class life (for example, 39.5 years for nonresidential real property), many remodeling projects arguably could be deducted under the safe harbor, regardless of the nature or extent of the work involved."[16] We fail to see how a building's class life provides any significantly different opportunity for "remodeling" projects to occur than during the 18-year life of a towboat, 14-year life of a freight car or 12-year life of an aircraft. The issue turns on the characteristics of the project, not the opportunity to undertake it. We submit that the simple fact that a building has a longer class life than other complex units of property does not justify disparate treatment of the building's required maintenance and imposition of a subjective facts-and-circumstances analysis for each and every repair of a building. Moreover, by providing extensive rules that distinguish "routine maintenance" from "remodeling projects," the Temporary Regulation already safeguard against the deductions envisioned in the Preamble. Accordingly, we see no reason that buildings should not qualify for the routine-maintenance safe harbor under Treas. Reg. § 1.263(a)-3T(g) and urge the Treasury Department and the Service to permit buildings and their structural components to qualify for the safe harbor.

[16] 76 Fed. Reg. at 81070. We also note that under § 168(c), the recovery period for nonresidential real property is 39 years.

V. "Refresh" expenditures, "new or different use" rule

a. Additional guidance needed on "refresh" expenditures

RILA appreciates the inclusion of "building refresh" examples in the Temporary Regulation, recognizing that retailers must refresh or spruce up their stores on a routine basis. Treas. Reg. § 1.263(a)-3T(h)(4) Exs. 6, 7 & 8. The appearance of the store and its layout are critical for retailers to remain competitive and provide the modern shopping environment that is paramount to the ever-changing demands of retail customers. It is also important to understand that refreshing retail spaces generally is not a function of whether or not the asset (i.e., the store) is working; rather, it is a function of marketing and providing customers with a pleasant and inviting atmosphere in which to shop. In this respect, retail stores are fundamentally different from manufacturing facilities, warehouses, general office space, etc., where the building is not customer-facing and appearances do not directly affect sales.

While the inclusion of the three refresh examples is a positive addition to the Temporary Regulations, we are concerned that they summarily reach conclusions regarding whether the activities constitute a betterment without a clear rule or bright line on which to base such results. Fundamental to this issue is the need for a materiality standard, as discussed above, given the underlying assumptions that the examples do or do not materially improve the building and/or its structural components. Similarly, a significant improvement would be the inclusion of objective factors on which retailers can judge whether or not the modifications comprising the store refresh step over the line into being a betterment.

The third refresh example – Example 8 – raises an additional concern regarding a store refresh that occurs contemporaneously with other significant changes to the building or its structural components. We understand that the Temporary Regulations do not incorporate the "plan of rehabilitation" doctrine, but rather apply the standard under § 263A to require the capitalization of indirect costs that directly benefit or are incurred by reason of an improvement to property.[17] Treas. Reg. § 1.263(a)-3T(f)(3). We question the basis for incorporating the principles of § 263A, which applies to the production of property or inventory and historically have not been associated with repairs. Nevertheless, it is difficult to discern how the § 263A standard is to be applied in the context of a retail store refresh.

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. Treas. Reg. § 1.263(a)-3T(h)(4) Ex. 7. The expenditures relating to the rest of the refresh (outlined in Example 6), however, are not implicated and are not required to be capitalized. *Id.* 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. *Id.* No other analysis is provided. In contrast, Example 8 concludes that the refresh work "directly benefits or was incurred by reason of" a substantial remodel to the store building.

[17] *See* Preamble, 76 Fed. Reg. at 81069-70.

Again, no further analysis of the interconnection between the refresh and the remodel is provided.

As noted in Example 6, store refreshes are an ordinary and necessary occurrence for retailers to remain competitive. Treas. Reg. § 1.263(a)-3T(h)(4) Ex. 6(i). Similarly, it is sound business and financial management to undertake other regular maintenance activities in conjunction with a store refresh, especially when there is an overlap in the service providers or when some portion or all of the store must be closed to consumers for any period of time. Thus, if the taxpayer would have undertaken the store refresh but for the other major maintenance or remodeling, and the expenses relating to the two activities can be accounted for separately, it stands to reason that taxpayers should be able to undertake both activities contemporaneously without the § 263A standard tainting the refresh expenditures.

A pure facts-and-circumstances analysis of refresh expenditures, without the benefit of an applicable materiality standard and clear delineation of the § 263A standard, simply consigns retailers to perpetual uncertainty and ongoing controversy on examination, with the continued potential for differing results among similarly situated taxpayers and even for a particular taxpayer from year to year. Furthermore, such an outcome is only magnified for retailers with thousands of stores and other facilities across the country and abroad.

RILA submitted a request in 2010 under the Industry Issue Resolution (IIR) program seeking guidance on refresh expenditures, which the Service deferred pending the release of the Temporary Regulations. We have renewed our request for specific guidance on the refresh issues through the IIR process with the expectation that the Treasury Department and the Service will build on the industry-specific guidance already issued for electric utilities, telecommunication network assets, and railroad track maintenance.[18]

b. Additional guidance on "new or different use" in the retail context

Related to the periodic refresh of a retail store are instances in which a retailer must adapt its retail facilities to accommodate changes in the retailer's product mix as well as the introduction of new products and services to meet changing consumer demands. Under the Temporary Regulations pertaining to expenditures to adapt property to a "new or different use," the general test is whether the expenditure is for an adaptation that "is not consistent with the taxpayer's intended ordinary use of the unit of property at the time originally placed in service by the taxpayer." Treas. Reg. § 1.263(a)-3T(j)(1). The examples relating to retail facilities suggest that as long as the building adaptations do not deviate from the facility's original purpose of retail sales, it will not constitute a new or different use. Treas. Reg. § 1.263(a)-3T(j)(3) Exs. 2 & 3.

We believe that the Temporary Regulations could be improved by adding an additional example to demonstrate that the "intended ordinary use" for retail facilities is *retail sales* and that an adaptation to advance retail sales (e.g., changes in the product mix, bringing in new product lines, allocating floor space to merchandise-related services) do not constitute a "new or different use." RILA has included this issue as part of its renewed IIR request described above.

[18] *See* Preamble, 76 Fed. Reg. at 81067.

VI. Disposition of building components

a. Clarification of "reasonable method" for determining disposition losses

The Temporary Regulation's provisions permitting taxpayers to treat the retirement of a building component as a disposition and recognize the resulting loss are a positive addition to the new rules. Treas. Reg. § 1.168(i)-8T. We understand that this change was intended to prevent taxpayers from having to continue depreciating a retired component that has been replaced as part of the maintenance or improvement of a building.

The practical application of this new rule, however, presents significant challenges. As noted above, no previous requirement has existed for federal income tax or other business purposes to maintain systems that isolate, capture, and preserve detailed information on a component basis at the time the property was first placed in service. Similarly, retroactive data to track building costs on a component basis is simply not available, and with the various system conversions that retailers have undertaken over many years, such historic data will be impossible to obtain in many cases.

Additionally, fixed-asset software available to calculate federal income tax depreciation does not currently have specific capabilities to calculate a partial disposal of a unit of property. In order to dispose of a partial asset in a typical depreciation software package, it would be necessary to set up two new assets and then dispose of one new asset as a proxy for the partial asset. In addition to requiring significant manual implementation, such a work-around also has a serious downside: taxpayers and the Service will lose visibility to the original asset and will not be able to trace the original asset back to the purchase documentation.

Retirement losses are also likely to become a new specific area of controversy between taxpayers and the Service in examinations. With the focus on the disposal calculation, controversy issues will be pushed later into the audit life cycle, because substantiation of an asset is even more difficult at the end of its life cycle than the beginning when the item was purchased. As a result, rather than the current controversy over reasonable repairs deduction amounts, there will now be controversy over reasonable disposal deductions taken and the underlying detailed historical cost documentation, assumptions and calculations.

To mitigate these likely outcomes, taxpayers need additional certainty with respect to applying the retirement-loss provision given the lack of historic accounting data and existing recordkeeping systems to determine the adjusted basis and accumulated depreciation of building components, let alone those that have been previously retired for purposes of calculating the § 481(a) adjustment required under the Temporary Regulations. We recognize the latitude provided by the Temporary Regulation for taxpayers to use "any reasonable method that is consistently applied" to determine the basis and depreciation attributable to the component at issue. Treas. Reg. § 1.168(i)-8T(e)(2). However, the term "reasonable," like "materiality" discussed above, is inherently subjective, and we recommend that the Treasury Department and the Service provide additional guidance that includes specific examples of methods that, if employed, would be deemed reasonable.

We note that the recently issued Rev. Proc. 2012-20 addresses the use of sampling for dispositions based on the methodologies described in Rev. Proc. 2011-42, which is helpful.[19] At the same time, Rev. Proc. 2012-20 prohibits any sampling not described in Rev. Proc. 2011-42 – which specifically contemplates the use of other statistical methodologies, subject to a determination by a Statistical Sampling Coordinator regarding the acceptability of such methodologies. Nevertheless, Rev. Proc. 2012-20 seems not to recognize this process.[20] Because retail taxpayers sometimes rely on more efficient statistical methods consistently accepted by Statistical Sampling Coordinators, clarification of this issue would eliminate uncertainty for both taxpayers and the Service's examination teams.

Other examples of "reasonable" methods could include:

- Third-party construction indexing, valuation services, or software that estimates the replacement cost of a component at the time of its installation.
- A table of safe-harbor percentages issued by the Service that taxpayers could apply in lieu of taxpayers performing their own computations. For example, if a replacement roof was to cost $50,000 and the prior roof had been placed in service 10 years ago, the table might provide that the remaining basis of the roof upon disposition would be about 49 percent, or $24,393.[21] Under this approach, the taxpayer could rely upon this safe harbor as the remaining basis of the disposition.
- Expanded examples on taxpayer uses of statistical sampling to estimate the basis of dispositions within a year using a sample of current expenditures, where the remaining basis of those dispositions identified are projected to the population of all expenditures. While the remaining basis of the sample items could be determined using actual records or a safe-harbor method, the use of a statistical sample would allow the estimation of the basis for the many different asset types found within retail stores to be projected to all asset types.

Providing taxpayers with a safe harbor for acceptable valuation methods will help reduce uncertainty, especially for retail taxpayers endeavoring to apply the Temporary Regulations to hundreds or thousands of storefronts and other facilities with little, if any, basis information. Moreover, it will help improve compliance and reduce future audit disputes.

b. Permit a "reasonable method" for determining the placed-in-service date of building structural components

We are also concerned that the specific-identification method required under the Temporary Regulations to determine the placed-in-service date could create substantial compliance burdens

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[19] Rev. Proc. 2012-20, 2012-14 I.R.B. XX (Apr. 2, 2012); Rev. Proc. 2011-42, 2011-37 I.R.B. 318 (Sept. 12, 2011).
[20] *See, e.g.*, Rev. Proc. 2012-20, § 5.03(3) (adding new Appendix § 6.29(8) to Rev. Proc. 2011-14).
[21] This simplified example assumes 10 years of inflation at a 3-percent annual rate (cumulatively 34 percent) and 10 years of depreciation using a 39-year life (cumulatively 26 percent). The result for a current cost of $50,000 is a remaining basis of $24,393, or about 49 percent. This can be computed as: current cost x (1 - ((1+rate of inflation)^ years in service-1)) x (1 - (years in service / original recovery period)).

in the case of building structural components. Treas. Reg. § 1.168(i)-8T(f)(1). As noted above, without detailed records with respect to the building structural components now enumerated under the new rules, it may be impossible to determine when a specific sink or light fixture, for example, was placed in service. While we note the special rules for multiple asset accounts under Treas. Reg. § 1.168(i)-8T(f)(2), they do not appear to be well suited for multiple assets making up a building structural component. It also is unclear how the use of statistical sampling, as allowed under Rev. Proc. 2012-20, would apply when specific identification is required. Accordingly, we recommend that taxpayers be allowed to apply the same "reasonable method" approach, which they are permitted to use for determining disposition losses under the Temporary Regulations, for purposes of establishing the age of a retired building component.

c. Alternative election for disposition losses

As discussed above, the disposition-loss provisions for building components come with significant compliance costs and burdens in certain cases. For taxpayers in situations where the compliance challenges are particularly severe, one mitigating approach would be to allow the taxpayer to elect to deduct the cost of the replacement property as a proxy for, and in lieu of, claiming the loss on the retired asset. Such an election would be analogous to the provision under the Temporary Regulations for taxpayers using a general asset account to forego a casualty loss under § 165 in favor of deducting the restoration costs.[22] *See* Treas. Reg. § 1.168(i)-1T; Preamble, 76 Fed. Reg. at 81074.

VII. De minimis rule/capitalization threshold

In addition to the treatment of expenditures for the repair of tangible property under Treas. Reg. § 1.263(a)-3T, we also note the de minimis rule set forth in Treas. Reg. § 1.263(a)-2T(g). We appreciate the retention of this bright-line rule with the intent of providing "an objective and administrable limit" on total de minimis expense deductions.[23]

a. A book-tax conformity rule would provide simplification and less administrative burden

As currently written, the de minimis rule requires taxpayers to analyze annually each and every asset that is expensed for GAAP reporting purposes upon acquisition to determine at the invoice level if the amount must be capitalized or expensed for federal income tax purposes. This is a tremendous burden for retailers that typically operate hundreds to thousands of locations and acquire many minor, de minimis assets as small as a broken door lock or replacement of a single sink in a restroom. Each time tax accounting deviates from GAAP accounting principles for

[22] We note that the Service further attempted to ameliorate the compliance burden by permitting late elections for general asset accounts by filing a Form 3115, pursuant to Rev. Proc. 2012-20.[22] However, while such a late election permits taxpayers to avoid disposition losses for historic properties on a going forward basis, this flexibility is only offered through an accounting-method change for a brief transition period. On a going forward basis, a taxpayer that inadvertently fails to elect general asset account treatment during the placed-in-service year for real property would still be forced to account for disposed building components (thereby creating an administrative burden) or to seek relief through a request for private letter ruling (thereby creating a cost burden).

[23] Preamble, 76 Fed. Reg. at 81064.

items regarding fixed assets, complexity is added to track the various differences accurately. Likewise, it increases the opportunity for errors to occur. As a result, both the Service's auditors and taxpayers will spend additional manual hours reconciling the differences between book and tax fixed-asset accounting, thereby increasing the controversy related to the timing of the deductions.

Moreover, the Temporary Regulations do not provide enough guidance for taxpayers that exceed the total threshold calculated under the de minimis rule. The examples included in the Temporary Regulations only explain the results of a single purchase that exceeds the calculated threshold amount. *See e.g.*, Treas. Reg. § 1.263(a)-2T(g)(8) Exs. 2 & 3. This is not realistic as most companies purchase thousands of assets a year through thousands of individual transactions. Based on the current rules, it is unclear what assets a taxpayer must capitalize once the company exceeds the threshold. Does the taxpayer apply a "first in, first capitalized" approach, a "last in, first capitalized" basis,[24] or some other method for assets purchased over and above the de minimis limitation?

Instead of establishing new calculations, elections, exclusions and other nuances under the de minimis rule, RILA recommends that the Temporary Regulations apply a de minimis book-tax conformity rule. Such a rule would eliminate considerable compliance burdens, costs and inevitable disputes, while still achieving the objective of providing a bright-line rule for expensed amounts, particularly for those taxpayers subject to the scrutiny of an independent audit for GAAP purposes.

Absent such a book-tax conformity rule, we urge the Treasury Department and the Service to increase the de minimis threshold in order for it to be effective and realistic. The current limits (0.1 percent of gross receipts reported for federal income tax purposes or 2 percent of total book depreciation) results in a very low threshold to be applied to a building-intensive industry, like retail, that is not allowed a routine maintenance exception under the Temporary Regulations consistent with other types of property. Such a low de minimis threshold will inevitably result in a large capitalization of tax-only assets with respect to items that are truly de minimis assets for individual retailers and adversely affect one industry over another.

b. Application of the de minimis rule to consolidated groups

We are also concerned about the de minimis rule's inconsistent application to consolidated groups. On the one hand, the Temporary Regulations appropriately provide that a single group-wide written accounting procedure for de minimis expenses is sufficient if applicable to each group member. Treas. Reg. § 1.263(a)-2T(g)(7). Yet, on the other hand, the de minimis rule examples indicate that the 0.1-percent/2-percent threshold must be determined on a member-by-member basis. *See* Treas. Reg. § 1.263(a)-2T(g)(8) Exs. 2 & 3. We believe that the latter requirement will be extremely difficult to implement for companies with consolidated groups, putting large companies operating through complex entity structures at a disadvantage.

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[24] A last-in-first-capitalized basis could lead to the adverse result of a taxpayer inadvertently having to apply the mid-quarter convention even though less than 40 percent of the assets purchased were not acquired during the fourth quarter.

If the de minimis rule is maintained in its current form, the application of the threshold test to each separate legal entity will also impose extensive tracking burdens on taxpayers operating through consolidated groups. In addition, a taxpayer that has several entities may not reach the calculated consolidated threshold based on the entities that generate revenue versus the entities that own the property. Accordingly, the current de minimis rule would not provide an accurate, consistent result representative of such a consolidated taxpayer.

In light of these issues, RILA recommends that the de minimis calculations and threshold be applied based on the applicable financial statement of the consolidated group, rather than the individual group members, to eliminate some administrative burden and potential controversy.

VIII. Transition Issues and Effective Date Relief

As noted above, the fact that the Temporary Regulations were published four days prior to their general effective date at the start of this year has created significant challenges for retailers seeking to understand the new rules and implement them with no real transition period. While we appreciate the recent guidance regarding accounting method changes required under the Temporary Regulations,[25] retailers, and all taxpayers alike, face a daunting task in terms of understanding the new regulations and filing the necessary accounting method changes, including extremely complicated § 481(a) adjustments in many cases – all without a transition period before the new regulations went into effect.

Rev. Proc. 2012-19 and Rev. Proc. 2012-20 include guidance on the use of statistical sampling, which is quite helpful but incomplete and confusing in certain respects. Accordingly, we request clarifying language and further guidance with regard to the following:

- As noted above, the Revenue Procedures prohibit the use of statistical sampling that is not described in Rev. Proc. 2011-42, while Rev. Proc. 2011-42 itself contemplates other methods and calls for their review by Statistical Sampling Coordinators. We request that clarification be provided that other statistical sampling methodologies not described in Rev. Proc. 2011-42, but acceptable to the Statistical Sampling Coordinators, will be allowed.
- Rev. Proc. 2012-19 and Rev. Proc. 2012-20 provide language allowing the use of statistical sampling for certain accounting method changes, but are silent on the use of statistical sampling for other method changes. We understand that the Service's intent is that the use of statistical sampling for these other method changes should be reviewed during examination rather than prohibited. We ask for written guidance providing that statistical sampling is allowed for any method change, or that statistical sampling may be allowed for any method change upon examination team review.
- Rev. Proc. 2011-43 provides an extrapolation procedure applicable to repairs of electric transmission and distribution property.[26] Under this procedure, a taxpayer is generally

[25] Rev. Proc. 2012-19, 2012-14 I.R.B. XX April 2, 2012; Rev. Proc. 2012-20, *supra*.
[26] Rev. Proc. 2011-43, 2011-37 I.R.B. 326 (Sept. 12, 2011).

allowed to review expenditures for a minimum test period of at least three consecutive years, including the year of the accounting method change, and apply a resulting adjustment rate reflecting the difference between its existing and new capitalization policies as a percentage of capital expenditures, per the taxpayer's financial records, to earlier years. *Id.* at Appendix A. Because retailers have assets with similarly long or longer useful lives, the need for such a provision is at least as great or greater. Otherwise, it will be highly burdensome to apply the same accounting method changes to all potentially affected expenditures with a remaining tax basis. We note that Rev. Proc. 2011-43 provides a haircut on the adjustment for periods prior to the test period that increases rapidly as the number of years prior to the test period increases. *Id.* While we understand the logic for such a haircut, this adjustment is excessive for taxpayers with long-lived assets like the retail industry. Accordingly, we ask that it be reduced if an extrapolation methodology is provided for retail taxpayers.

Lastly, we have serious concerns about the immediate effective date of the Temporary Regulations, given the complexity and uncertainty surrounding the Temporary Regulations and the enormity of the implementation issues facing retailers. The Temporary Regulations will likely require significant accounting systems changes to account for new items required under the new rules (e.g., items under the de minimis rule and to track the separate tax bases of each building system). Because the regulations became effective only a few days after they were issued, retailers have not had the time to establish the requisite systems to apply on a prospective basis, and as of now they will have to apply any systems changes retroactively, which will create administrative burdens and record-keeping inaccuracies.

We note that Rev. Proc. 2012-19 and Rev. Proc. 2012-20 provide certain relief for accounting-method changes filed for the taxpayer's first or second tax year after December 31, 2011.[27] We strongly urge the Treasury Department and the Service to afford taxpayers the same transition period to conform to the Temporary Regulations. **Specifically, taxpayers should be allowed to elect to apply the Temporary Regulations for either their first or second taxable year beginning on or after January 1, 2012.** Such relief would permit taxpayers time to make the necessary recordkeeping-systems changes and determine the required § 481(a) adjustments, without adversely affecting the operation of their businesses.

Concluding remarks

RILA appreciates the opportunity to comment on the Temporary Regulations and provide insights on their significant impact on the retail industry. We recognize that these regulations have been almost a decade in the making and that rules on which taxpayers can rely are essential to improving compliance and reducing controversies. Nevertheless, RILA urges the Treasury Department and the Service to consider the issues and recommendations outlined in this letter to ensure that the Temporary Regulations, and ultimately the final regulations, provide clear, administrable rules and minimize the compliance burdens on taxpayers.

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[27] *See, e.g.*, Rev. Proc. 2012-20, § 5.03(3) (adding new Appendix § 6.29(2) to Rev. Proc. 2011-14).

We would be pleased to discuss RILA's views with you further at your convenience.

Respectfully submitted,

Kirt Johnson
Vice President, Tax Policy

cc: Lisa Zarlenga
Tax Legislative Counsel
U.S. Department of the Treasury

Alexa Claybon
Taxation Specialist
U.S. Department of the Treasury

Andrew Keyso
Associate Chief Counsel
Office of the Chief Counsel, Income Tax & Accounting
Internal Revenue Service

Scott Dinwiddie
Special Counsel
Office of the Chief Counsel, Income Tax & Accounting
Internal Revenue Service

Kathleen Reed
Branch Chief
Office of the Chief Counsel, Income Tax & Accounting
Internal Revenue Service

Merrill Feldstein
Senior Counsel
Office of the Chief Counsel, Income Tax & Accounting
Internal Revenue Service