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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JOSEPH F. MASELLI
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FROM: PAUL F. KUGLER
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SUBJECT: Depreciation of Tires and Tubes

This Field Service Advice responds to your memorandum received by this office on November 1, 2000, regarding the matter referenced above. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

LEGEND

Taxpayer =

ISSUES

1. Whether the cost of tires and tubes purchased for new vehicles must be capitalized and recovered through depreciation, or is such cost currently deductible as a business expense?

2. If the cost of the tires and tubes must be capitalized, are the tires and tubes treated as separate assets for depreciation purposes and, if so, over what recovery period are they depreciated?

3. If the cost of tires and tubes must be capitalized, and tires and tubes are treated as separate assets for depreciation purposes, how is the cost of replacement tires and tubes recovered?

4. Whether a change from currently deducting the cost of tires and tubes to capitalizing and depreciating such cost is a change in method of accounting?

CONCLUSIONS

1. If the factual development indicates that the tires and tubes at issue have a useful life of more than one year, the cost of the tires and tubes must be capitalized and recovered through depreciation. Otherwise the cost is currently deductible.

2. If the cost of the tires and tubes must be capitalized, the tires and tubes are treated as assets separate from the vehicles for depreciation purposes. The recovery period for the tires and tubes is 5 or 8 years.

3. If the cost of replacement tires and tubes must be capitalized, their cost is recovered in the same manner as the cost of new tires and tubes.

4. A change from currently deducting the cost of tires and tubes to capitalizing and depreciating the cost is a change in method of accounting.

FACTS

Taxpayer has strict maintenance and operating procedures that enable the vehicles to remain in operation for 25 years or more. For each of the years at issue, Taxpayer purchased numerous new vehicles, most of them without tires. Taxpayer contracted separately with tire companies, purchased the tires in bulk, and arranged to have the tires placed on the vehicles.

Taxpayer is an accrual basis taxpayer. During the years at issue, Taxpayer deducted as a current operating expense the cost of the tires and tubes for its new vehicles in the month in which it capitalized the cost of the vehicles. Thereafter, Taxpayer deducted as a current operating expense the cost of replacement tires and tubes. Taxpayer's treatment of tires and tubes for new vehicles and replacement tires and tubes was consistent with its practice during previous years. Taxpayer contends that tires and tubes are rapidly consumable separate assets. The Service believes that its ongoing factual development will show that Taxpayer's tires and tubes last several years.

LAW AND ANALYSIS

Issues 1, 2, and 3

Section 162 of the Internal Revenue Code allows a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business. However, section 263(a) prohibits a deduction for capital expenditures. Capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. Section 1.263(a)-2(a) of the Income Tax Regulations. Such capital expenditures are subject to the allowance for depreciation.

Section 167(a) provides a depreciation allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income.

The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in section 168(a) and the other method is the alternative depreciation system in section 168(g). Under either depreciation system the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of either section 168(a) or 168(g), the applicable recovery period is determined by reference to class life or by statute. Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former section 167(m) as if it were in effect and the taxpayer were an elector. Prior to its revocation, section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) sets out the method for asset classification under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.

Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowances under section 168. The revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The same item of depreciable property can be described in both an asset category (that is, asset classes 00.11 through 00.4) and an activity category (that is, asset classes 01.1 through 80.0), in which case the item is classified in the asset category. See Norwest Corporation & Subsidiaries v. Commissioner, 111 T.C. 105 (1998) (item described in both an asset and an activity category (furniture and fixtures) should be placed in the asset category). The asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 00.241, Light General Purpose Trucks, includes trucks for use over the road that weigh less than 13,000 pounds. Trucks in this class have a recovery period of 5 years for purposes of both sections 168(a) and 168(g).

Asset class 00.26, Tractor Units for Use Over-The-Road, provides a 3-year recovery period for purposes of section 168(a) and a 4-year recovery period for purposes of section 168(g) for vehicles includible in this class.

Asset class 00.27, Trailers and Trailer-Mounted Containers, provides a 5-year recovery period for purposes of section 168(a) and a 6-year recovery period for purposes of section 168(g) for assets includible in this class.

Asset class 42.0, Motor Transport--Freight, includes assets used in the commercial and contract carrying of freight by road, except for transportation assets included in classes with the prefix 00.2. Assets in this class have a recovery period of 5 years for purposes of section 168(a) and 8 years for purposes of section 168(g).

Rev. Rul. 59-249, 1959-2 C.B. 55, holds that the cost of tires and tubes on new commercial trucking equipment purchased and used by the taxpayer in motor freight transportation is deductible in full as ordinary and necessary business expense in the taxable year of purchase if such tires and tubes are consumable within that year or their average useful life is less than one year even though it extends in part into the next year.

Rev. Rul. 68-134, 1968-1 C.B. 63, holds that the principles of Rev. Rul. 59-249 are applicable to tires in the case of a taxpayer who is a purchaser-lessor of new commercial trucking equipment.

Rev. Rul. 69-560, 1969-2 C.B. 25, holds that the cost of tires and tubes purchased by the taxpayer on new highway construction equipment that it uses or leases is deductible in full as ordinary and necessary business expense in the taxable year of purchase where such tires and tubes have an average useful life of less than one year.

Rev. Rul. 73-357, 1973-2 C.B. 40, holds that the cost properly allocable to tires and tubes on used construction equipment purchased by the taxpayer is deductible as an ordinary and necessary business expense in the taxable year of purchase if their average remaining useful life is less than one year.

The revenue rulings discussed above were issued in the context of several court cases that had addressed the treatment of the cost of tires and tubes purchased with vehicles and equipment. W.H. Tompkins Co. v. Commissioner, 47 B.T.A. 292 (1942); Interstate Truck Service, Inc. v. Commissioner, T.C. Memo. 1958-219; Zelco, Inc. v. Commissioner, 331 F.2d 418, 421 (1st Cir. 1964). In support of its conclusion that the cost of truck tires and tubes consumable within the taxable year purchased are currently deductible as business expense, the court in Tompkins noted that while it could not allow as an expense every part of a truck's mechanism that might wear out in less than a year, the tires and tubes are easily separable from the truck and are not a part of the truck's mechanism. The court thought it "absurd" to associate the short-lived tires' cost recovery with the depreciation of the much longer-lived trucks. In Interstate the court allowed the current deduction of the cost of tires and tubes even though not all of the tires and tubes at issue were consumable within the taxable year of purchase. However, the court found that on average all of the tires and tubes were consumable in less than one year. After discussing both of these cases, Rev. Rul. 59-249 announces that the Service will follow these decisions. Rev. Rul. 68-134 discusses the Zelco decision, noting that the appellate court concluded that a lessor of vehicles was not required to treat tires as a part of the leased vehicles.

The cases and revenue rulings discussed above stand for the proposition that tires and tubes are not treated as part of a vehicle for depreciation purposes. Rather, they are considered to be separate assets and, as such, their cost is currently deductible by a purchaser provided they are consumable in less than one year. It is of critical importance to note that in each of these cases and revenue rulings the tires and tubes at issue were consumable in less than a year. Accordingly, if the factual development shows that the tires and tubes at issue in the present case have an average useful life to Taxpayer of more than one year, their cost cannot be currently deducted by Taxpayer as an operating expense. Their cost must be capitalized and recovered through depreciation. For purposes of our continuing analysis, we will assume that the tires and tubes at issue have an average useful life of more than one year.

As stated previously, the preceding cases and revenue rulings conclude that tires and tubes are separate assets from the vehicles or equipment to which they are attached. Because they are not considered to be part of the vehicle for depreciation purposes, they are not associated with any of the specific transportation assets included in the asset classes of Rev. Proc. 87-56 with the prefix 00.2. Therefore, in accordance with section 168 and Rev. Proc. 87-57, tires and tubes that must be capitalized are depreciated as assets used in specific business activities. In the present case, Taxpayer's business activity is described in asset class 42.0, Motor Transport--Freight. Assets in this class have a recovery period of 5 years for purposes of section 168(a), and 8 years for purposes of section 168(g).

The preceding analysis is equally applicable to Taxpayer's replacement tires and tubes. If Taxpayer's replacement tires and tubes have an average useful life to Taxpayer of more than one year, their cost must be capitalized and recovered through depreciation. As discussed above, tires and tubes are treated as assets separate from the vehicles for depreciation purposes. Because, under section 168, all of Taxpayer's tires and tubes, whether original or replacement, would be depreciated as assets used in Taxpayer's motor transport–freight business activity (asset class 42.0), Taxpayer's replacement tires and tubes would be depreciated in the same manner as Taxpayer's new tires and tubes. Therefore, Taxpayer's replacement tires and tubes would have a recovery period of 5 years for purposes of section 168(a), and 8 years for purposes of section 168(g).

Issue 4

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis on which the taxpayer regularly computes its income in keeping its books.

Section 446(b) provides that if the taxpayer's method of accounting does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. Section 1.446-1(a) provides that the term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item.

Section 1.446-1(e)(2)(ii)(a) provides that 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 used in such overall plan. The section further provides that a material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.

Although a method of accounting may exist without the necessity of a pattern of consistent treatment of an item, section 1.446-1(e)(2)(ii)(a) also provides that in most instances a method of accounting is not established for an item without consistent treatment. The erroneous treatment of a material item in the same way in two or more consecutively filed federal tax returns represents the consistent treatment of that item. See Rev. Rul. 90-38, 1990-1 C.B. 57.

Section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include an adjustment in the useful life of a depreciable asset or a change in treatment resulting from a change in underlying facts. However, the section also provides that a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets that had been consistently treated as an expense in the year of purchase is to be treated as a change in method of accounting.

In the present case, Taxpayer has expensed the cost of tires and tubes on its federal tax returns for two or more consecutive years and, as a result, has adopted this expensing treatment as the method of accounting for the tires and tubes even if such treatment is erroneous. See section 1.446-1(e)(2)(ii)(a); Rev. Rul. 90-38. A change from expensing to capitalizing and depreciating the cost of tires and tubes involves the timing of deductions and, thus, is a change in method of accounting. Section 1.446-1(e)(2)(ii)(b). If Taxpayer's tires and tubes should be capitalized, then Taxpayer's present method of accounting for their cost would not satisfy the clear reflection of income requirement of section 446(b). Under section 446(b) the Service could compute Taxpayer's taxable income in accordance with a method that clearly reflects Taxpayer's income. Accordingly, a change in method of accounting would be necessary to clearly reflect Taxpayer's income.

Further, none of the exceptions under section 1.446-1(e)(2)(ii)(b) apply in the present case. There is not a change in the useful life of an asset that Taxpayer was capitalizing and depreciating. Instead, there is a change to capitalization of an asset that Taxpayer was expensing. Therefore, the "adjustment in the useful life of a depreciable asset" exception does not apply. Similarly, Taxpayer has not identified any change in underlying facts that occurred in the year of change that would justify a change from expensing to capitalizing the cost of the tires and tubes.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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If you have any questions regarding this Field Service Advice, please call (202) 622-3110.

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