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

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LM:NR:DEN

FROM: Kathleen Reed
Acting Branch Chief, Branch 6
Office of Passthroughs and Special Industries, CC:PSI

SUBJECT: Interaction of Percentage Repair Allowance and CLADR System

This Chief Counsel Advice responds to your memorandum dated September 19, 2001. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

A =
B =
C =
Date1 =
Date2 =
Date3 =
Date4 =
FSA = FSA 199919019 (February 10, 1999)

ISSUES

1. Whether property transferred to A in years subsequent to the Class Life Asset Depreciation Range (CLADR) period of 1971 through 1980 in transactions to which section 381(a) applies, is eligible for the percentage repair allowance (PRA) under section 1.167(a)-11(d)(2) of the Income Tax Regulations when no CLADR election was made by the transferor to apply the CLADR system in the CLADR years for the property.

2. Where A has acquired property in a transaction to which section 381(a) applies, and the transferor has made a CLADR election with respect to this property, can A combine the acquired CLADR property with its existing vintage accounts, or must A

segregate the acquired property into vintage accounts separate from its existing vintage accounts.

CONCLUSIONS

1. A cannot use the PRA on property transferred to A after 1980 in a transaction to which section 381(a) applies when no election was made by the transferor to apply the CLADR system during the CLADR years for the property.

2. A must segregate the CLADR assets acquired by A in a transaction to which section 381(a) applies into vintage accounts separate from its existing vintage accounts.

FACTS

A, a subsidiary of B, made Class Life Asset Depreciation Range (CLADR) elections and is continuing to use the CLADR system with respect to assets acquired by A during the period 1971 through 1980. A also made elections under section 1.167(a)-11(d)(2)(ii) to use the percentage repair allowance (PRA) available under the CLADR provisions with respect to these assets. The primary benefit to A of using the CLADR system is the application of the percentage repair allowance (PRA).

From Date1 through Date2, A consisted of B, a holding company, and C, an operating company. Beginning in Date2, B and C were involved in a series of mergers and acquisitions that resulted in the creation of A (as it is called today) in Date4. These transactions are subject to section 381. In these transactions, the transferor made the CLADR election for the transferred assets in some, but not all, of the years 1971 through 1980. Nevertheless, A has combined the transferred assets into its existing vintage accounts and has been applying the PRA.

This case is currently under examination for taxable years ending Date3 through Date4.

LAW AND ANALYSIS

ISSUE 1:

Section 263(f) of the Internal Revenue Code of 1954[1] is applicable to property placed in service after 1970 and prior to 1981 and provides:

“REASONABLE REPAIR ALLOWANCE- The Secretary may by regulations provide that the taxpayer may make an election under which amounts representing either

[1]Section 263(f) was redesignated as section 263(e) on February 2, 1977.

repair expenses or specified repair, rehabilitation, or improvement expenditures for any class of depreciable property -

(1) are allowable as a deduction under section 162(a) or 212 (whichever is appropriate) to the extent of the repair allowance for that class, and

(2) to the extent such amounts exceed for the taxable year such repair allowance, are chargeable to capital account.

Any allowance prescribed under this subsection shall reasonably reflect the anticipated repair experience of the class of property in the industry or other group.

Section 1.263(f)-1(a) provides that for rules regarding the election of the repair allowance authorized by section 263(f), the definition of repair allowance property, and the conditions under which an election may be made, see paragraphs (d)(2) and (f) of section 1.167(a)-11 for such taxable year. An election may be made under this section for a taxable year only if the taxpayer makes an election under section 1.167(a)-11 for such taxable year. [Emphasis added.]

Section 1.167(a)-11(a)(1) provides, in part, that in general, a taxpayer may not apply any provision of section 1.167(a)-11 unless the taxpayer makes an election and thereby consents to and agrees to apply, all the provisions of section 1.167(a)-11.

Section 1.167(a)-11(b)(5)(i) provides that except as otherwise provided in section 1.167(a)-11(d)(2) dealing with expenditures for the repair, maintenance, rehabilitation, or improvement of certain property, no provision of section 1.167(a)-11 shall apply to any property other than eligible property to which the taxpayer elects in accordance with section 1.167(a)-11, to apply section 1.167(a)-11.

Section 1.167(a)-11(b)(5)(ii) provides that, with certain stated exceptions, a CLADR election applies to all eligible property first placed in service by the taxpayer during the taxable year of election. The exceptions include property described in section 1.167(a)-11(e)(3)(i) and (iv) dealing with transactions to which section 381(a) applies. Section 381(a) applies to acquisitions of assets of a corporation by another corporation in (1) a distribution to which section 332 applies or (2) a transfer to which section 361 applies, but only if the transfer is in connection with certain types of section 368(a)(1) transactions.

Section 1.167(a)-11(d)(2) provides for the treatment of repairs under CLADR. Section 1.167(a)-11(d)(2) provides an alternative means to those of sections 162, 212, and 263 for the treatment of certain expenditures for the repair, maintenance, rehabilitation, or improvement of property. Section 1.167(a)-11(d)(2) provides an elective, simplified procedure for determining whether repairs with respect to certain property are to treated as deductible expenses or capital expenditures.

Section 1.167(a)-11(d)(2)(ii) provides that in the case of an asset guideline class that consists of repair allowance property, the taxpayer may elect to apply the asset guideline class repair allowance described in section 1.167(a)-11(d)(2)(iii) for any taxable year ending after December 31, 1970, for which the taxpayer elects to apply section 1.167(a)-11. Section 1.167(a)-11(d)(2)(iii) provides, in relevant part, that the determination of whether property is repair allowance property shall be made without regard to whether such property is excluded, under section 1.167(a)-11(b)(5), from an election to apply section 1.167(a)-11.

Section 1.167(a)-11(e)(3)(i)(a) provides that in general, the acquiring corporation in a transaction to which section 381(a) applies is for purposes of section 1.167(a)-11 treated as if it were the distributor or transferor corporation.

Section 1.167(a)-11(e)(3)(i)(c) provides that the acquiring corporation (in transaction(s) to which section 381(a) applies) may apply section 1.167(a)-11 to the property so acquired only if the distributor or transferor corporation elected to apply section 1.167(a)-11 to such property.

Section 203(b) of the Economic Recovery Tax Act of 1981 (the "Act"), 1981-2 C.B. 256, 283, terminated CLADR for recovery property placed in service after December 31, 1980. In addition, section 201(c) of the Act, 1981-2 C.B. at 282, repealed the repair allowance election under section 263(e) with respect to property placed in service after December 31, 1980. Thus, taxpayers could elect to apply section 1.167(a)-11 to property placed in service before December 31, 1980. For property placed in service after December 31, 1980, CLADR was superseded by the Accelerated Cost Recovery System. However, the CLADR repair allowance continued to be in effect for expenditures that, although incurred after December 31, 1980, were for the repair, maintenance, rehabilitation, or improvement of property placed in service before January 1, 1981. [2]

In FSA, we concluded that a taxpayer could not elect to use the PRA provisions of section 1.167(a)-11 without having elected into all the CLADR rules found at section 1.167(a)-11. However, because A has made an argument that it can use the PRA for property acquired in transactions subject to section 381(a) where the transferor corporation did not elect CLADR for the particular taxable year and such argument relies on CLADR regulations not addressed in FSA, you have requested clarification of FSA on this issue.

You have told us that A has made an argument that, based on the regulations, it can use the PRA for property acquired pursuant to transactions subject to section 381(a) where the transferor corporation did not elect the CLADR system for the particular taxable year. Specifically, A argues that the language of section

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[2] See footnote #1 of U.S. v. Wisconsin Power and Light Co., 38 F.3d 329 (7th Cir. 1994).

1.167(a)-11(a)(1) states only "in general" that a taxpayer may not apply any provision of the section unless he makes an election and thereby consents to and agrees to apply all the provisions. A notes that section 1.167(a)-11(b)(5)(i) excepts portions of section 1.167(a)-11(d)(2) (including the PRA) from the general requirement of section 1.167(a)-11(a)(1) that no provision of the section shall apply to any property other than eligible property to which the taxpayer elects to apply this section. In particular, section 1.167(a)-11(d)(2)(iii) provides, in relevant part, that the determination of whether property is repair allowance property shall be made without regard to whether such property is excluded, under section 1.167(a)-11(b)(5), from an election to apply section 1.167(a)-11. As such, A argues that the PRA can still be used for section 381(a) property excluded from the CLADR election and, as a result, A concludes that it can apply the PRA provision of section 1.167(a)-11 to any and all section 381(a) property, regardless of whether the transferor of such property made a CLADR election for such property during the CLADR years. A's position is that, at least with respect to section 381(a) property, it is not a prerequisite to the PRA election that the transferor corporation have made a CLADR election for such property.

Your position is that A's analysis is incorrect because it ignores a key provision of section 1.167(a)-11(d)(2)(ii) and requires an inconsistent interpretation of the CLADR regulations and, thus, such a result is contrary to the laws of statutory interpretation.

You provided an analysis as to the interpretation of this particular issue, and we agree with it. Your analysis is as follows: The PRA regulation specifically requires as a precondition to electing the PRA that the taxpayer have made a primary CLADR election for the assets in issue. Section 1.167(a)-11(d)(2)(ii) provides, in relevant part, that the taxpayer may elect to apply the asset guideline class repair allowance described in section 1.167(a)-11(d)(2)(iii) for any taxable year ending after December 31, 1970, for which the taxpayer elects to apply section 1.167(a)-11. [Emphasis added] See also section 1.263(f)-1(a).

For property in a transaction to which section 381(a) applies, the acquiring corporation is treated for purposes of the CLADR regulations as if it were the transferor corporation. Section 1.167(a)-11(e)(3)(i)(a). With respect to such property, the method of depreciation adopted by the transferor is binding on the acquiring corporation, absent consent of the Commissioner. Section 1.167(a)-11(e)(3)(i)(b). Further, the acquiring corporation may apply section 1.167(a)-11 to the property so acquired only if the transferor corporation elected to apply section 1.167(a)-11 to such property. Section 1.167(a)-11(e)(3)(i)(c).

Thus, with respect to property acquired in a section 381(a) transaction, the prerequisite CLADR election required by section 1.167(a)-11(d)(2)(ii) is the election, if any, made by the transferor corporation. For this class of property, the CLADR election is, in effect, constructively made for the acquiring corporation by the transferor corporation.

With this background, the fact that the determination (under section 1.167(a)-11(d)(2)(iii)) of whether property is repair allowance property is made without regard to whether the property is excluded (under section 1.167(a)-11(b)(5)(ii)) from the CLADR election does not, when interpreted in the context of section 1.167(a)-11(e)(3), support A's position. Section 1.167(a)-11(b)(5)(ii) necessarily provides an exception for property acquired in a section 381(a) transaction because, under section 1.167(a)-11(e)(3)(i), the transferor's election of CLADR (or lack thereof) controls. If a transferor did not elect CLADR treatment for the section 381(a) property, such property cannot be included in an acquiring corporation's CLADR election. Section 1.167(a)-11(b)(5)(ii) would be inconsistent with the special rule for section 381(a) property provided by section 1.167(a)-11(e)(3)(i) if it did not contain an exception for such property.

Moreover, while it is correct that PRA property may include property excluded from the CLADR election (section 1.167(a)-11(d)(2)(iii)), it does not logically follow that a taxpayer may elect PRA treatment without any CLADR election ever having been made. To the contrary, the portion of section 1.167(a)-11(d)(2)(iii) relied upon by A is expressly predicated upon the existence of an underlying CLADR election. ("The determination whether property is repair allowance property shall be made without regard to whether such property is excluded . . . from an election to apply this section [emphasis added].") This language is consistent with similar language in other CLADR provisions. See section 1.167(a)-11(a)(1), 1.167(a)-11(d)(2)(d)(ii), and, with respect to section 381(a) property, 1.167(a)-11(e)(3), as discussed above.

Based on the foregoing analysis, you conclude that the above regulations prohibit A from electing PRA treatment for property it acquired in transactions subject to section 381(a) where the transferor of such property did not elect CLADR treatment. As previously stated, we agree with your analysis and, thus, we agree with your conclusion.

ISSUE 2:

Under section 1.167(a)-11(b)(3)(i), a taxpayer that has elected CLADR is required to maintain vintage accounts that are closed-end depreciation accounts containing eligible property, first placed in service by the taxpayer during the taxable year of election. Section 1.167(a)-11(b)(3)(i) also provides that more than one account of the same vintage may be established for different assets of the same asset guideline class.

Section 1.167(a)-11(b)(3(ii) provides special rules for determining what types of property may be placed in the same vintage account. One of these rules is that property the original use of which does not commence with the taxpayer may not be placed in a vintage account with property the original use of which commences with the taxpayer. Section 1.167(a)-11(b)(3)(ii) also refers to section 1.167(a)-11(e)(3)(i) for special rules for property acquired in a transaction to which section 381(a) applies.

Section 1.167(a)-11(e)(3)(i)(a) provides that in general, the acquiring corporation in a transaction to which section 381(a) applies is for purposes of section 1.167(a)-11 treated as if it were the distributor or transferor corporation.

Section 1.167(a)-11(e)(3)(i)(b) provides that if the distributor or transferor corporation (including any distributor or transferor corporation of any distributor or transferor corporation) has made an election to apply section 1.167(a)-11 to eligible property transferred in a transaction to which section 381(a) applies, the acquiring corporation must segregate such eligible property (to which the distributor or transferor corporation elected to apply section 1.167(a)-11) into vintage accounts as nearly coextensive as possible with the vintage accounts created by the distributor or transferor corporation identified by reference to the year the property was first placed in service by the distributor or transferor corporation. The asset depreciation period for the vintage account in the hands of the distributor or transferor corporation must be used by the acquiring corporation. The method of depreciation adopted by the distributor or transferor corporation shall be used by the acquiring corporation unless such corporation obtains the consent of the Commissioner to use another method of depreciation in accordance with paragraph section 1.446-1(e) or changes the method of depreciation under section 1.167(a)-11(c)(1)(iii).

In FSA, we concluded that under section 1.167(a)-11(e)(3)(i)(b), the segregated assets must be kept separate, and not put into the same account as assets with similar vintage account years. Because A has made an argument that assets acquired in a transaction to which section 381(a) applies where the transferor corporation made a CLADR election can be placed in an existing vintage account of the acquiring corporation, relying on the words “as nearly coextensive as possible” in section 1.167(a)-11(e)(3)(i)(b), you have requested clarification of FSA on this issue.

In this case, A’s vintage accounts for CLADR property must be closed-end depreciation accounts. Section 1.167(a)-11(b)(3)(i). As such, A may not add assets to these vintage accounts after the taxable year of election made by A.

Furthermore, we have reviewed your interpretation of section 1.167(a)-11(e)(3)(i)(b), and we agree with it. Your interpretation, in part, provides that the acquiring corporation must maintain “segregated” vintage accounts of CLADR assets that it received in a transaction to which section 381(a) applies, and these vintage accounts must mirror as closely as possible, i.e., be as nearly coextensive as possible with, the vintage accounts that existed in the transferor corporation prior to the transfer. Under this reading, “coextensive” does not mean commingling of the acquired accounts with existing accounts of the acquiring corporation. Therefore, A must segregate the CLADR assets acquired by A from a transferor corporation in a transaction to which section 381(a) applies into vintage accounts separate from A’s existing vintage accounts.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

KATHLEEN REED
Acting Branch Chief, CC:PSI:B6