INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director, Field Operations
Heavy Manufacturing & Transportation

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

X =
Y =
$x =
$y =
year 1 =
year 2 =
year 3 =
year 4 =
year 5 =
year 6 =
year 7 =
year 8 =
A =
B =
C =
D =
Date H =

ISSUE(S):

1. For purposes of § 1031 of the Internal Revenue Code, are components of railroad track that are assembled and attached to the land and considered real property for state law purposes of like-kind to unassembled railroad track components?

2. In the case of a taxpayer electing the track maintenance allowance method under Rev. Proc. 2001-46, 2001-2 C.B. 263, does the taxpayer's failure to specifically identify and substantiate whether replacement property acquired in a like-kind exchange is used in a capital project preclude nonrecognition under § 1031?

3. If § 1031 applies to the exchanges, is the taxpayer using a proper method of accounting when it applies an accounting convention that deems § 1031 replacement property to be used first for capitalized track expenditures (including the 60% capitalized portion of the program replacement expenditures)?

4. Does the Service's execution of a closing agreement regarding treatment of track structure expenditures for years 1, 2, and short period year 3, preclude it from raising Issue 3 for the years at issue in this case?

5. Is the taxpayer entitled to § 7805(b) relief with respect to Issue 3?

CONCLUSION(S):

1. Components of railroad track that are assembled and attached to the land and considered real property for state law purposes are not of like-kind to unassembled railroad track components considered personal property for state law purposes.

2. If the requirements of § 1031 are met, gain or loss is deferred when a taxpayer acquires railroad track components in a like-kind exchange notwithstanding that the taxpayer is unable to substantiate whether the acquired property was used for repair, program replacement, or new track construction.

3. The taxpayer's practice of deeming § 1031 replacement property to be used first for capitalized track expenditures (including the 60% capitalized portion of the program replacement expenditures) is not proper. In particular, the first to capital convention of allocation is not consistent with the requirements of Rev. Proc. 2001-46 and may violate the reasonableness requirements of § 1.263A-1(f) of the Income Tax Regulations.

4. The Service is not precluded from raising Issue 3 for the years at issue in this case.

5. The taxpayer is not entitled to relief under § 7805(b)(8).

FACTS:

X and Its Track

During the years in question, X had subsidiaries that operated Class I railroads. X built and maintained track on its own rights of way. Track is built on an elevated "road bed" comprised of soil, sub-ballast (stone), ballast (smaller stone), crossties, and rail. The ties and rail are held in place by other track material (OTM). In the United States, once track is built, it is almost never replaced all at once, but is maintained continuously.

The issues in this case focus on the three main categories of track: (1) rails, (2) ties, and (3) ballast. The rail category also includes OTM, which consists of many miscellaneous steel components necessary to track construction such as spikes, bolts, tie plates, switches, and anchors. Thus, the term "rail" is used to refer to all steel track components.

"Repairs": X performs nearly 100 percent of track maintenance with its own work force. Localized groups of employees spread throughout the track network or system monitor the tracks and conduct routine repairs and maintenance in their areas. This never-ending work includes everything from bolt tightening, spike driving, and isolated rail grinding, to spot installation of crossties, and installation of lengths of rail less than a quarter mile in length. Immediate safety needs detected through daily visual inspection (walking the tracks) trigger much of this work, while some is preventative maintenance. X funds this work out of its operating (expense) budget and reports its cost on the Schedule 410, Railroad Operating Expense schedule of Form R-1, for regulatory purposes. In Rev. Proc. 2001-46, these costs are defined as *Operating Items*.

"Program replacements": For work that requires larger quantities of material replacement, X maintains system gangs. These groups of highly skilled workers operate specialized equipment, traveling throughout the railroad's system, replacing one or more components over multi-mile segments. Railroads use sophisticated surveillance equipment and historical profiles to identify the need for this work, referred to as program replacement (because it is planned or programmed well in advance). Program replacement sometimes includes upgrades, e.g.: larger tie plates, harder steel, heavier rail, more durable ballast. X funds this work out of its capital budget and, for regulatory purposes, reports its costs on Schedule 330 of Form R-1, Annual Capital Additions. In Rev. Proc. 2001-46, these costs are included in the definition of *Current Additions*.

"New track": In addition to the above, X typically has significant new track construction each year. Although significantly less than program replacements, this new track work is still substantial. This work is just what its name implies--construction, from the ground up, of new track. Railroads report the new track construction costs on Schedule 330, Annual Capital Additions, for regulatory purposes. In Rev. Proc. 2001-46, these costs are included in the definition of Current Additions, as a subset referred to as *New Track Structure*.

Materials handling and inventory: X plans its capital additions several years in advance. It identifies track components in need of replacement or upgrade early in order to have the materials on hand for processing and installation. Sufficient supplies are maintained in inventories around the system to meet the needs for local repairs and maintenance, program replacement projects, and new track construction.

While suppliers often deliver ties and ballast directly to the job site for capital work, rail, the most expensive track component, is shipped to the railroads from the steel plants in 78 to 80 foot lengths. X uses third party rail welding/rail manufacturing plants for processing this rail. As needs come to the forefront, these plants produce the proper weight rail lengths for X. The short lengths are welded into 1/4 mile strands, then stored in X's supplies inventory until needed. Hundreds of miles of new rail are processed in this fashion every year. Typically, the taxpayer uses the rail, as well as ties and ballast, for program replacement, with substantial but lesser quantities going to new track and still lesser amounts allocated to the local forces for routine repairs and maintenance.

Accounting for track assets: Historically, for book, regulatory, and tax purposes, railroad track has been accounted for in three separate asset accounts, even though none of the three functions independently from the other two. Ties are accounted for in asset account 8, rail in asset account 9, and ballast in asset account 11. There is not, and never has been, an asset account for the functioning asset – railroad track; yet until these components are installed in the track, they have no working purpose. Consistent with this practice, depreciation, (and in prior years, investment tax credit) is not claimed until the asset is installed on the ground as part of the railroad track.

X's Exchanges of Track

Assets relinquished: X exchanged two types of assets. First, X exchanged intact line segments. The eventual buyers of the intact line segments were other railroads. In a line segment exchange, the entire property was relinquished in place – the land, the sub-grade, the ties, rail and ballast, and the supporting superstructures such as culverts, bridges, trestles and tunnels. These transactions totaled $x.

Second, rail and ties that had been removed from a line segment were exchanged (component exchange). These materials were then sold on the secondhand market to scrap dealers or third party suppliers and railroads for eventual use in lower traffic density tracks. The used components exchanged totaled $y for the years in question.

The rails, ties, and ballast relinquished in the exchanges had a zero adjusted basis for tax purposes. X claimed deferral of all of the proceeds from its dispositions of these assets under the like-kind exchange provisions of § 1031.

Assets Acquired: In exchange for both the line segments and the used component parts, X acquired new component materials with which to manufacture replacements for its track system. Additionally, X acquired other new component materials in other transactions. The line segments X relinquished and those that it acquired in the exchanges were situated in 14 different states.

Use of an intermediary: The exchange transactions were coordinated through a qualified intermediary, Y, (an unrelated party), to effect the exchanges. In all cases, X complied with the procedural aspects of the deferred exchange rules of § 1031(a)(3) and § 1.1031(k)-1 of the regulations.

Types of exchanges: In the years at issue, while X had various combinations of exchanges of track property, the types of exchanges at issue in the present case are those involving the following:

(1) the exchange of used components, no longer affixed to the ground, for new component materials (component–component); and

(2) the exchange of an intact line segment for the new component materials (line-component).

As discussed more fully below, X does not know the extent to which the components acquired in like-kind exchanges were used for repair projects, replacement projects, or new track projects. X did not attempt to trace these materials to their actual applications.

State law considerations

We are assuming for purposes of this technical advice memorandum that all of the intact line segments exchanged by X were real property under applicable state law. X disputes this contention.

First to capital convention

Before Rev. Proc. 2001-46 was issued, there were disputes between railroads and the Internal Revenue Service regarding capitalization of railroad track structure expenditures. Rev. Proc. 2001-46 was issued as a "means to minimize disputes" regarding a railroad's track structure expenditures related to acquiring, constructing, maintaining, repairing, and improving track structure. The revenue procedure offers taxpayers a safe harbor method (the track maintenance allowance method) that eliminates uncertainty about whether track expenditures should be expensed or capitalized. It does so by defining the extent to which each of three categories of track expenditures ("new track expenditures," "repair expenditures," and "current improvements") will be expensed or capitalized.

Before Rev. Proc. 2001-46, disputes between the Service and railroads mainly concerned "program replacement expenditures." On an industry-wide basis, controversy over the proper tax treatment of program replacements led to Rev. Proc. 2001-46. Rev. Proc. 2001-46 provides a safe harbor formula under which 60 percent of such expenditures are capitalized and 40 percent expensed. Accordingly, railroads electing the track maintenance allowance method are no longer required to evaluate and substantiate the extent to which costs of components used in each separate program replacement project should be classified as costs for repairs or improvements. Instead, such railroads apply a mathematical formula to the information listed on or derived from the Form R-1 filed with the STB. The Form R-1 contains separate line items for additions to each of the components of track structure (rails, ties, and ballast). The track maintenance allowance method uses line item amounts from the Form R-1 as the starting points for application of the safe harbor method.

X acquired approximately 80% of the components (ballast, rails, ties, and other track material) for track structures through purchases and 20% of its components through purported like-kind exchanges. As a result, X's basis in the purchased components is its cost basis under § 1012, while its basis in the exchanged property is a carryover basis under § 1031(d), which is zero.

During the years at issue, X did not attempt to track components acquired in like-kind exchanges to their ultimate use. It does not know to what extent these components were used for repair projects, replacement projects, or new track projects.

For book and regulatory accounting purposes, X values track structure components obtained through like kind exchanges at the value of the relinquished property. For tax accounting purposes, X has adopted a convention that it has named the "first to capital" convention.

Under the first to capital convention, X's accounting for the cost of components for track structure starts with the amounts determined under its book accounting method. X then applies Rev. Proc. 2001-46 to the cost of track structure components as reflected on its books to obtain an aggregate amount that is required to be capitalized under Rev. Proc. 2001-46. This amount is then reduced by an amount intended to reflect the gain that was deferred as a result of disposing of assets (and acquiring replacement property) through like kind exchanges. In some of the years at issue, the amount of the deferred gain exceeded the cost of components used for new track construction. Thus, in summary, X's first to capital convention treats the property acquired in § 1031 exchanges as being used in connection with capital projects (new track structure and the portion of program replacement that is capitalized under Rev. Proc. 2001-46), while the higher basis property, acquired through purchase, was applied to expensed items (repair projects and the portion of program replacement that is expensed).

Rev. Proc. 2001-46 does not address like-kind exchanges or whether a taxpayer may follow a convention in which assets acquired in like-kind exchanges are used first for capital purposes.

Closing Agreement

Rev. Proc. 2001-46 was issued on August 21, 2001. Section 8 of the revenue procedure offers taxpayers the option to settle open tax years by agreeing to adopt the track maintenance allowance method beginning in their earliest open year. To effect this settlement, the revenue procedure requires the taxpayer and the Service to execute a closing agreement affirming that the taxpayer has been placed on the method and finalizing the adjustments to reflect the new method.

As of August 21, 2001, X's open years (for purposes of making the track maintenance allowance method election) included years under the jurisdiction of Appeals (year 1 through the short period year 3) as well as subsequent years under the jurisdiction of Exam. One of the issues subject to Appeals jurisdiction was the issue addressed by Rev. Proc. 2001-46, i.e., the issue of the extent to which costs of components used in program replacements must be capitalized. On its returns, X used the "first to capital" convention described above. Exam had not challenged the taxpayer's use of this method of accounting for the years under Appeals jurisdiction.

Following issuance of Rev. Proc. 2001-46, A had a telephone conversation with B concerning X's open years. B suggested that X prepare and send to Exam the computations required under Section 8.03(2)(e) of Rev. Proc. 2001-46. Exam would then review the computations and make any charges it thought necessary. Consequently, (i) X provided Exam with track structure computations for the years before Appeals and (ii) Exam reviewed, made corrections and extensive schedules, and approved the computations as corrected. These computations reflected that X had treated property acquired through § 1031 exchanges entirely as property that was capitalized.

X was also concerned with the computations for the open years still under Exam's jurisdiction because the election under section 8 of Rev. Proc. 2001-46 had to be made for all open years. Exam thus began preparing and sending to X preliminary track structure computations utilizing the track maintenance allowance method for the years covered by this TAM. Mirroring the computations for the earlier years prepared by the taxpayer, these computations treated property acquired through § 1031 exchanges entirely as property that was capitalized. D, who had reviewed and corrected the computations for the earlier years and prepared the computations for years 3 through 5, stated that he did not consider the propriety of X's approach to the § 1031 reductions while reviewing and preparing the computations.

X then turned to a procedural concern. If X was to elect the track maintenance allowance method for open years, it needed to file an amended tax return for before making the election and executing the closing agreement. See Rev. Proc. 2001-46, Section 8.05(4). This caused a problem because the numbers necessary for amending the return would not be available for some time, and X wished to close out the years in Appeals in a prompt fashion. X thus suggested that the closing agreement be executed before the amended return was filed. X would then enter into a second closing agreement covering the later years, and the amended return would be filed before the execution of the second closing agreement. Accordingly, the closing agreement for the early years was executed on Date H.

Before execution of the closing agreement, C questioned X's use of the first to capital convention of allocation. In response to such concerns, A sent a letter to D explaining X's position regarding the first to capital convention of allocation. The letter concluded, "We are proceeding under the assumption that you will continue to find X's historical treatment of reinvestment proceeds acceptable under the revenue procedure."

The closing agreement was executed on Date H. The drafters of the closing agreement did not consult with C about any language in the closing agreement. Further, C never saw or reviewed the computations underlying the closing agreement. Thus, the closing agreement was signed without knowledge of C's unresolved concern regarding X's use of the first to capital convention of allocation.

The "Whereas" portion of the closing agreement included the following language:

4. The issue covered in this closing agreement is the taxpayer's treatment of track structure expenditures incurred as a result of performing various activities to acquire, construct, maintain, repair, and improve track structure. The definition of "track structure expenditures" and other items defined in section 4 of Rev. Proc. 2001-46, apply for purposes of this closing agreement.

5. The taxable years covered by this closing agreement are [years 1, 2, and short period year 3].

6. The taxpayer currently accounts for track structure expenditures using the facts and circumstances method of accounting.

The “Determination” portion of the closing agreement provided as follows:

NOW IT IS HEREBY DETERMINED AND AGREED for Federal Income Tax purposes that:

1. That the Service is changing the taxpayer’s method of accounting for track structure expenditures to the track maintenance allowance method of accounting described in section 5 of Rev. Proc. 2001-46, for the taxable year [3].

2. That the method change will be implemented using a cut-off method.

3. That the adjustments to taxable income necessary to reflect the new method and any collateral adjustments to taxable income or tax liability resulting from the change for each of the taxable years covered by this agreement, are as follows:

[figures omitted]

4. That the Service waives the timing aspect of the requirement of section 8.05(4) of Rev. Proc. 2001-46(4)(b) that any amended returns must be filed on or before the execution of this closing agreement.

5. That by electing the method of accounting described in Rev. Proc. 2001-46 the taxpayer has committed to settling its [year 3 through year 7] pursuant to the same method of accounting pursuant to the provisions of Rev. Proc. 2001-46 and to filing any amended returns required by section 8.05(4) of Rev. Proc. 2001-46, to reflect the settlement.

6. That the Service will not require the taxpayer to change its method of accounting for track structure expenditures to a method other than the track maintenance allowance for any taxable year for which a federal income tax return has been filed as of the date of this closing agreement, provided that: (a) the taxpayer has complied with all the applicable provisions of the closing agreement; (b) there has been no taxpayer fraud, malfeasance, or misrepresentation of a material fact; (c) there has been no change in the material facts on which the closing agreement was based; and (d) there has been no change in the applicable law on which the closing agreement was based.

7. That the Service is not precluded from challenging the computation of the track maintenance allowance for any taxable year covered by this closing agreement on a basis unrelated to the track maintenance allowance method (for example, that all or a portion of the amount is not incurred under § 461 or that the taxpayer

has not properly applied the uniform capitalization rules of § 263A and the regulations thereunder).

8. That the taxpayer accepts this settlement and agrees to the applicable terms of Rev. Proc. 2001-46.

With the exception of items 4 and 5, above, the closing agreement contained substantially the same language as the closing agreement shown in the Appendix to Rev. Proc. 2001-46.

LAW AND ANALYSIS:

<u>Issue 1</u>

Section 61(a)(3) provides that gross income includes income from gains derived from dealings in property. Such gains are determined under § 1001.

Section 1031 provides an exception to the general rule relating to gains from dealings in property. Under § 1031(a)(1), no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1.1031(k)-1 of the regulations provides rules for deferred like-kind exchanges. Under § 1.1031(k)-1(a), a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and, within a prescribed time period, identifies and receives property to be held for productive use in a trade or business or for investment (the "replacement property").

Section 1.1031(a)-1(b) of the regulations provides that the words “like kind”, as used in § 1031(a), have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under § 1031(a), be exchanged for property of a different kind or class. Thus, the fact that real estate is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

It is well-established in case law that real property is not of the same nature or character as personal property. Thus, real property and personal property are not like kind under § 1031(a). Accordingly, in the present case, any relinquished property consisting of components of railroad track that are assembled and attached to the land and considered real property for state law purposes cannot be considered like kind to unassembled and unattached components, which are personal property under applicable state law.

In Oregon Lumber v. Commissioner, 20 T.C. 192 (1953), the taxpayer exchanged a fee simple interest in real property for a limited right to cut and remove standing timber. The court found that the cutting rights were personal property under Oregon law and held that "[a]n exchange of realty for personalty is not an exchange of property for property of like kind. " 20 T.C. at 196.

In Smalley v. Commissioner, 116 T.C. 450 (2001), the court considered a similar issue to that considered in Oregon Lumber. In discussing Oregon Lumber, the court reiterated that "the taxpayer's exchange was of realty for personalty and was thus not an exchange of properties of like kind." 116 T.C. at 461.

Finally, in Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941), the court considered whether a parcel of real estate was of like kind to other real estate. In deciding they were of like-kind, the court stated as follows: "For the [§ 1031] regulation and the interpretation under it, leave in no doubt that no gain or loss is realized by one, other than a dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property." (emphasis added). Id. at 184.

The taxpayer, in the present case, argues that the phrase "nature or character" in § 1031(a)-1(b) of the regulations embodies two separate concepts and that while realty is of a different character than personalty, it can be of the same nature. The taxpayer therefore concludes that, because both the relinquished property and the replacement property consist of track components, those properties are of the same nature and are like-kind property notwithstanding that the relinquished and replacement property are of a different character. The taxpayer also points to the anomaly of the Service considering an exchange to be of like kind properties in some states but not in others depending on whether the property is considered real or personal under the applicable state law.

We reject the taxpayer's arguments for a number of reasons. First, the taxpayer cites no authority for its position that "nature or character" as discussed in § 1031(a)-1(b) embodies two separate concepts. The taxpayer cannot point to a single case holding that real property was of like-kind to personal property. Moreover, as discussed above, there are numerous cases taking the contrary position that real property and personal property can never be of like kind. Finally, we do not accept the taxpayer's argument that an anomalous result would ensue were property to be of like-kind in some states but not in others. It is well-established that "[i]n the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayers had in the property or income sought to be reached by the statute." Morgan v.

Commissioner, 309 U.S. 78, 82 (1940). Thus, since state law controls whether property is realty or personalty for federal income tax purposes, it is not uncommon for the federal income tax treatment of such property to vary depending on the controlling state law (e.g, the rules relating to depreciation).

Accordingly, any relinquished property consisting of components of railroad track that are assembled and attached to the land and considered real property for state law purposes are not like kind under § 1.1031(a)-1(b) of the regulations to unassembled and unattached components, which are personal property under applicable state law.

Issue 2

The second issue concerns whether X's failure to specifically identify and substantiate that the replacement property was used in a capital project precludes nonrecognition under § 1031. Section 1031 requires that the relinquished property and the replacement property (1) be exchanged; (2) be used in the taxpayer's trade or business or for investment; (3) be of like-kind (as described in §§ 1.1031(a)-1(a)(2) and 1.1031(a)-2); and (3) not be one of the properties described in § 1031(a)(2). There is no requirement under § 1031 that the replacement property be used for capital purposes (i.e., used in new construction rather than for repair).

In the present case, X does not know the extent to which the components acquired in like-kind exchanges were used for repair projects, replacement projects, or new track projects. X did not attempt to trace these materials to their actual applications. However, it is clear that acquired property was used in X's trade or business. Accordingly, because there is no requirement in § 1031 that replacement property be used for capital purposes, any gain or loss realized on the exchange of relinquished track components for new track components is deferred under § 1031 provided the other requirements of that section are met.

Issue 3

Issue 3 relates to whether X's first to capital convention of allocation is a proper method of accounting. For the reasons discussed below, the first to capital convention of allocation is not consistent with the requirements of Rev. Proc. 2001-46, and may violate the reasonableness requirements of § 1.263A-1(f).

Rev. Proc. 2001-46

Taxpayer is required by its closing agreement to apply Rev. Proc. 2001-46. The operative provisions of Rev. Proc. 2001-46 require that tax adjustments be made before determining the track maintenance allowance or the capitalized amount. Because the first to capital convention adjusts basis for amounts of gain that are not recognized under § 1031 after the track maintenance allowance and capitalized amounts are determined, it fails to comply with Rev. Proc. 2001-46.

Section 5 of Rev. Proc. 2001-46 provides rules for determining the amount of the track maintenance allowance and the capitalized amount. The starting point for making this determination is determining the track structure expenditures for the taxable year. See § 5.02(1) of Rev. Proc. 2001-46.

Track structure expenditures for a particular year are the sum of the taxpayer's current additions, operating items and removal costs. See § 4.02 of Rev. Proc. 2001-46. Section 4.03 of the revenue procedure indicates that current additions are amounts "that represent additions to the taxpayer's track structure, that are taken into account for federal income tax purposes (see, e.g., §§ 404 and 461)." Section 4.03 goes on to specify that "[t]hus, for example, current additions do not include the assigned value of relay materials." The assigned value of relay materials are amounts that reflect a taxpayer's fair market value adjustments (excluding rewelding and other processing costs) for track materials that were previously retired for financial reporting purposes. The assigned value of relay materials does not include relay track materials purchased by the taxpayer. See § 5.05 of Rev. Proc. 2001-46.

Section 4.03 indicates amounts reported as current additions for financial reporting purposes are to be adjusted for federal income tax purposes before being used to calculate the track maintenance allowance or the capitalized amounts. Section 4.03 specifically references not only §§ 404 and 461 but also basis adjustments made to account for the assigned value of relay materials. Like the basis adjustments for the assigned value of relay materials, the basis of property acquired in a like-kind exchange should be accounted for in determining the amount of current additions under § 4.03 of Rev. Proc. 2001-46. Nothing in the revenue procedure authorizes making some basis adjustments under § 4.03 while deferring other basis adjustments until after determining the track maintenance allowance or capitalized amounts. Accordingly, the first to capital convention does not comply with the literal requirements of Rev. Proc. 2001-46 because it does not properly calculate the amount of current additions.

Section 1.263A-1(f)(4)

Not only does the first to capital convention fail to comply with the literal requirements of Rev. Proc. 2001-46, it also may fail to comply with the requirements of § 263A. Section 263A generally requires direct costs and an allocable portion of indirect costs of real or tangible personal property produced by a taxpayer to be capitalized to the property produced. Section 263A(g) defines produce as including constructing, building, installing, manufacturing, developing, or improving. See also § 1.263A-2(a)1)(i). In this case, § 263A requires X to capitalize its cost of producing track. See Rev. Proc. 2001-46.

Section 263A requires that the costs that are capitalized be reasonably allocated to the property produced. See § 1.263A-1(g). Section 1.263A-1(f)(4) describes when an allocation method will be judged reasonable. For the reasons discussed below, the first to capital convention is not reasonable within the meaning of § 1.263A-1(f)(4).

Section 1.263A-1(f) discusses various cost allocation methods that can be used to allocate direct and indirect costs to produced property. It specifically authorizes taxpayers to use (1) the specific identification method (§ 1.263A-1(f)(2)); (2) the burden rate or standard cost methods (§ 1.263A-1(f)(3)); or (3) any other reasonable method (§ 1.263A-1(f)(4)). X is not using the specific identification method, the burden rate method or the standard cost method. At issue is whether X is using another reasonable method under § 1.263A-1(f)(4).

Section 1.263A-1(f)(4) provides that a taxpayer may use a facts-and-circumstances allocation method if it is a reasonable allocation method. In addition, a taxpayer may use any other reasonable method to allocate direct and indirect costs among units of property produced or acquired for resale during the taxable year. An allocation method is reasonable if:

> (i) the total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in §§ 1.263A-1(f), 1.263A-2, or 1.263A-3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, and the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;
>
> (ii) the allocation method is applied consistently by the taxpayer; and
>
> (iii) the allocation method is not used to circumvent the requirements of the simplified methods provided in §§ 1.263A-1(f), 1.263A-2, or 1.263A-3, or the principles of § 263A.

Whether X's method is reasonable depends on X's facts and circumstances. X asserts that it satisfies the reasonableness requirements of § 1.263A-1(f)(4)(i) because the total costs actually capitalized under the first to capital convention do not differ significantly from the aggregate costs that would be capitalized using another permissible method. In particular, X reasons that the results of the first to capital convention do not differ from those it could have obtained had it used a specific identification method. This reasoning is based on the assumption that X would be able to trace components that were obtained in like-kind exchanges solely to capital projects.

Whether X's method is reasonable depends on X's facts and circumstances and thus, generally is best left to the field. In this case, X's reasoning fails because it does not take into account X's obligation to use Rev. Proc. 2001-46, supra, under the closing agreement. Section 1.263A-1(f)(4)(i) requires comparison of X's present method to a permissible method. Given the constraints of the closing agreement, the only permissible methods for X are methods that employ Rev. Proc. 2001-46. Even assuming X is correct that it could specifically identify components used for capital projects[1], X is still required to apply the revenue procedure. Section 5 of the Rev. Proc. 2001-46 uses an aggregate approach to determining the amount of capital expenditures. Under this aggregate approach, a flat percentage of certain amounts are deducted currently regardless of whether those amounts are associated with projects that otherwise are capital in nature. This aggregate approach will invariably result in less amounts being capitalized than under the first to capital convention.[2] A reasonable allocation method would not capitalize amounts that differ significantly from the amounts required to be capitalized by Rev. Proc. 2001-46.

Issue 4

Issue 4 addresses whether the closing agreement executed on Date H by X and the Service precludes the Service from raising Issue 3 for years 3, 4, and 5.

Section 7121 authorizes the Commissioner to enter into closing agreements. While these agreements are creatures of statute, they remain subject to general principles of contract law. United States v. National Steel Corp., 75 F.3d 1146 (7th Cir. 1996); In re Spendthrift Farm, 931 F.2d 405 (6th Cir. 1991); Rink v. Commissioner, 100 T.C. 319 (1993). As such, the scope of these agreements is limited to those matters clearly addressed in the written document. Smith v. United States, 850 F.2d 242, 245 (5th Cir. 1988); Rink, 100 T.C. at 325 (stating that "[c]ontract law principles generally direct that we look within the "four corners" of the agreement."); Zaentz v. Commissioner, 90 T.C. 753, 762 (1988) (stating that "section 7121 does not bind the parties as to the premises underlying their agreement; they are bound only as to the matters agreed upon.").

The closing agreement at issue in this matter is a Form 906, "Closing Agreement on Final Determination Covering Specific Matters." It places the taxpayer on the track maintenance allowance method pursuant to Rev. Proc. 2001-46, and finalizes adjustments made to taxable income for years 1, 2 and the short period year 3, that are

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[1] Whether X has sufficient costing information available to use a specific identification method under § 1.263A-1(f)(4) has not been raised as an issue by X or the field.

[2] Similarly, any argument that X's method is reasonable because the amount capitalized under it does not differ significantly from the amount that would be capitalized if X specifically traced the cost of components obtained in like-kind exchanges to new track structures (within the meaning of Rev. Proc. 2001-46) also fails as the basis adjustments in several years exceed the cost of components for new track structures.

necessary to reflect this new accounting method. X now argues that the closing agreement covers like-kind exchanges and their effect on the first to capital convention in the years at issue. We question whether it functions to accomplish anything for these years, other than to recite the obvious and necessary fact that X, by changing a method of accounting, is bound by that change for years beyond those specifically covered in the agreement.

The taxpayer in this present case makes an argument that has been rejected numerous times in the past by various courts. In Smith v. United States, 850 F.2d 242, 245 (5th Cir. 1988), the taxpayers urged the court to bar the Service from assessing interest and penalties for liabilities in 1978 and 1979 where there was a closing agreement that settled those liabilities for those years but did not address interest and penalties. The taxpayers argued that there was an underlying agreement as to the interest and penalties. The court disagreed, holding the parties to the terms of the agreement and permitting assessment by the Service. Similarly, other courts have allowed the Service to raise issues that were not specifically covered in a closing agreement. See In re Spendthrift Farm, 931 F.2d 405 (involving attempt to bar the Service from assessing interest and penalties); Zaentz v. Commissioner, 90 T.C. 753 (refusing to bar the Service from questioning the business purpose of certain transactions and trusts, the court concluded that, “[u]nder section 7121 a court may not include as part of the agreement matters other than the matters specifically agreed upon and mentioned in the closing agreement.”). In each of these cases, the court held that the parties to the closing agreements were bound only as to those issues specifically mentioned in the written agreement.

The language in the present closing agreement states that certain years are covered by this agreement, specifically years 1, 2, and the short period year 3. Determination clause 3 states:

> That the adjustments to taxable income necessary to reflect the new method, and any collateral adjustments to taxable income or tax liability resulting from the change for each of the taxable years covered by this agreement, are as follows:
>
> [figures omitted]

(Emphasis added.)

By specifically identifying years 1, 2, and the short period year 3 as the taxable years covered by the closing agreement and excluding any other years from that statement, the closing agreement shows that the parties principally intended to cover only those taxable years identified in Determination clause 3. We note that the “Whereas” paragraphs contain a statement that also reflects the limited coverage of this agreement. The fifth Whereas clause provides that “[t]he taxable years covered by this agreement are [years 1, 2, and the short period year 3].”

To the extent that the closing agreement addresses tax years other than those years, the discussion is limited in nature and purpose. Determination clause 5 states: "That by electing the method of accounting described in Rev. Proc. 2001-46 the taxpayer had committed to settling its [year 3 through year 9] years pursuant to the same method of accounting pursuant to the provisions of Rev. Proc. 2001-46…" This Determination clause is a mere recitation of the fact that by changing the method of accounting and adopting the Rev. Proc. 2001-46 method of accounting for prior years, X was statutorily bound to this method under § 446(e).

Whereas the closing agreement is very clear about placing X on the accounting method described in Rev. Proc. 2001-46, it is silent as to the handling of like-kind exchanges and their effect on the first to capital convention. The terms placing X on the accounting method provided by Rev. Proc. 2001-46 do not require a specific handling of the like-kind exchange basis adjustment/first to capital convention issue for the years at issue here. Because the agreement functioned to allow X to adopt the method of accounting set forth in Rev. Proc. 2001-46, a method which does not address like-kind exchanges/first to capital convention, issues concerning this fall out of the agreement. Furthermore, section 7 of the closing agreement specifically allows the Service to raise § 263A issues. As such, the Service is not precluded from raising issues related to the like-kind exchange basis/first to capital convention for the years at issue.

Issue 5

The fifth issue concerns whether X should be granted relief under § 7805(b). If such relief is granted, Issue 3 would be applied prospectively only.

Section 7805(b)(8) provides that "the Secretary may prescribe the extent, if any, to which any ruling . . . (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws, shall be applied without retroactive effect." Section 301.7805-1(b) of the Procedure and Administration Regulations provides that the Commissioner may prescribe the extent, if any, to which any ruling relating to the internal revenue laws, issued by or pursuant to authorization from the Commissioner, shall be applied without retroactive effect.

Section 23.02 of Rev. Proc. 2003-2, 2003-1 I.R.B. 76, at 106, provides, in relevant part, that a holding in a technical advice memorandum (TAM) that is adverse to the taxpayer is applied retroactively unless an Associate Chief Counsel, an official of the Office of Chief Counsel, exercises the discretionary authority under section 7805(b) to limit the retroactive effect of the holding.

Section 23.06 of Rev. Proc. 2000-3, indicates that, in general, relief under § 7805(b) is granted in a TAM when a taxpayer has relied to its detriment on a published position of the Service or on a letter ruling or TAM previously issued to that taxpayer that is being modified or revoked by the TAM.

In the present case, X did not rely on any income tax regulation, revenue ruling, notice, or revenue procedure explicitly addressing its first to capital convention method of accounting. Further, X did not rely on a previously issued private letter ruling or technical advice memorandum covering the issues which might form a basis for § 7805(b)(8) relief. Rather, X's argument for favorable § 7805(b)(8) treatment is that, based on the negotiations involved in entering into the Date H closing agreement, it believed its method of accounting had been accepted by the Service. X further argues that, had it known the first to capital method of accounting issue was not a settled issue, it could have ensured that the replacement property acquired in its like-kind exchanges was used only in capital projects.

X, therefore, relied on its own interpretation of the law and facts, which, if erroneous, is not a basis for relief under § 7805(b)(8). Moreover, we question whether there is any merit to X's assertions. First, the closing agreement executed on Date H provides as follows:

> . . . the Service is not precluded from challenging the computation of the track maintenance allowance for any taxable year covered by this closing agreement on a basis unrelated to the track maintenance allowance method (for example, that all or a portion of the amount is not incurred under § 461 or that the taxpayer has not properly applied the uniform capitalization rules of § 263A and the regulations thereunder).

Thus, because the agreement provides that the Service may raise computational issues, including those relating to § 263A, for the years covered by the closing agreement, X was on notice that those same issues could be raised for the years at issue in this case. Second, the years at issue in this TAM occurred before the closing agreement was entered into. Thus, when the closing agreement was signed, the replacement property for the years at issue in the present case had already been placed in service by X. We fail to see, therefore, how X relied on the closing agreement in using its "first to capital" convention method of accounting for the years at issue in this case since the replacement property X contends would have been used for capital projects only had already been placed in service when the closing agreement was executed.

Accordingly, X's arguments do not support nonretroactive application of this TAM under § 7805(b)(8).

CAVEAT(S):

No opinion is expressed herein concerning whether the deduction claimed by the taxpayer for repair expenditures is correct.

No opinion is expressed herein concerning whether any specific property is realty or personalty or the consequences of the exchange of property that is considered to be personal property under applicable state law, except as discussed with respect to Issue 2.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.