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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR ROBIN HERRELL, SPECIAL COUNSEL, CC:LM:HMT:CIN:1

FROM: Mark Pitzer
Senior Counsel, Branch 6, Office of Associate Chief Counsel
(Passthroughs and Special Industries), CC:PSI:6

SUBJECT: Request for Advice on "Retread" or "Recap" Tires

This is in reply to your request for advice dated June 5, 2002, regarding the proper accounting treatment of the cost of "retread" or "recap" tires (hereinafter, "retread tires"). Pursuant to § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice is not to be cited as precedent.

You requested assistance on the following issues:

1. Should a taxpayer who has not elected to account for the cost of original tires and replacement tires for all of its qualifying vehicles under the original tire capitalization method described in section 5 of Rev. Proc. 2002-27, 2002-17 I.R.B. 802 (the "OTC method") capitalize the cost of retread tires used as the original or replacement set of tires on its tractors, trailers and/or trucks?
2. Should a taxpayer who has elected to account for the cost of original tires and replacement tires for all of its qualifying vehicles under the OTC method treat retread tires acquired as the first set of tires on newly-acquired qualifying vehicles as "original tires" as that term is defined in section 3.02 of Rev. Proc. 2002-27?
3. Should a taxpayer who has elected to account for the cost of original tires and replacement tires for all of its qualifying vehicles under the OTC method treat retread tires that have been exchanged for original or replacement tires on qualifying vehicles as "replacement tires" as that term is defined in section 3.03 of Rev. Proc. 2002-27?

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Background

Many taxpayers that use tractors, trailers, and/or trucks in their businesses send the tires from these vehicles to retread companies when the tread depth is reduced to the limit for acceptable use. The retread companies then supply the taxpayers with retread tires. Under some arrangements, the retread company replaces the taxpayer's tires with different tires. In other situations, a retread company returns the same tire casings, with the treads restored, to the taxpayer. Furthermore, taxpayers sometimes purchase retread tires for initial use on newly acquired tractors, trailers, and/or trucks. Retread tires generally cost about 50% of the cost of new tires.

Rev. Proc. 2002-27 provides a safe harbor method of accounting for the cost of original and replacement tires for certain vehicles used in various business activities. Under this method, the OTC method (discussed further below), a qualifying vehicle's tires are treated as part of the vehicle for depreciation purposes.

Law and Analysis

Issue (1)

Section 162 allows a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-1(a) of the Income Tax Regulations provides that incidental repairs are among the items included in business expenses. Section 1.162-4 provides that the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense. However, § 1.162-4 also provides that the cost of repairs in the nature of replacements that arrest deterioration and appreciably prolong the life of the property must be capitalized and depreciated in accordance with § 167.

Section 263(a) provides that no deduction is allowed for (1) any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. See also § 1.263(a)-1(a).

Section 1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred to (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. However, the regulation also provides that amounts paid or incurred for incidental repairs and

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maintenance of property within the meaning of § 162 and § 1.162-4 are not capital expenditures under § 1.263(a)-1(a).

In W.H. Tompkins Co. v. Commissioner, 47 B.T.A. 292 (1942), the court stated that the recovery of the cost of short-lived truck tires and tubes should not be associated with the depreciation of much longer-lived trucks because the tires and tubes are easily separable from the truck and are not a part of the truck's mechanism. The court held, therefore, that the cost of truck tires and tubes consumable within the taxable year are currently deductible as an expense in the year of purchase.

In Interstate Truck Service, Inc. v. Commissioner, T.C. Memo. 1958-219, the court held that a taxpayer in the motor freight transportation business can currently deduct the cost of tires and tubes on trucks, tractors and trailers because on average all of the tires and tubes were consumable in less than one year.

In Rev. Rul. 59-249, 1959-2 C.B. 55, the Service followed the decisions of W.H. Tompkins Co. and Interstate Truck Service in holding that the cost of tires and tubes purchased on new commercial trucking equipment and used in motor freight transportation is deductible as ordinary and necessary business expense in full in the taxable year of purchase and payment (or accrual, where such method of accounting is regularly employed, for Federal income tax purposes, by the taxpayer) if in such use they 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.

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

Thus, a taxpayer who has not elected to account for the cost of original tires and replacement tires for all of its qualifying vehicles under the OTC method may not treat retread tires used as the original or replacement set of tires on newly acquired tractors, trailers and/or trucks as part of the vehicle for depreciation purposes. Rather, the taxpayer must treat these tires as separate assets and, consequently, the taxpayer may currently deduct the cost of the retread tires as a repair provided the retread tires are consumable in less than one year. However, if the retread process appreciably prolongs the tire's original useful life or materially increases its value, the taxpayer cannot currently deduct the cost of the retread tires as an operating expense, but must capitalize and recover this cost through depreciation.

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Issues (2) and (3)

Section 5.01 of Rev. Proc. 2002-27 provides that, under the OTC method, a qualifying vehicle's tires are treated as part of the vehicle and not as separate assets. In addition, under the OTC method, the rotation of a tire from one vehicle to another is not treated as a change in use within the meaning of § 168(i)(5). A taxpayer that uses the OTC method must use this method for the original and replacement tires of all of its qualifying vehicles.

Section 5.02 of Rev. Proc. 2002-27 provides that a taxpayer using the OTC method: (1) must capitalize the cost of the original tires of a qualifying vehicle and depreciate these tires under § 168 by using the same depreciation method, recovery period, and convention applicable to the vehicle on which the tires are first installed; (2) must treat the original tires of the qualifying vehicle as being disposed of at the same time the vehicle on which the tires were first installed is disposed of by the taxpayer; and (3) must deduct the cost of the replacement tires of the qualifying vehicle as an expense in the taxable year the replacement tires are installed on the vehicle by the taxpayer.

Section 3.02 of Rev. Proc. 2002-27 defines "original tires" as the first set of tires installed on a qualifying vehicle acquired by the taxpayer whether or not the vehicle was equipped with tires when acquired.

Section 3.03 of Rev. Proc. 2002-27 defines "replacement tires" as all other tires installed on a qualifying vehicle following the acquisition of the vehicle by the taxpayer.

Retread tires acquired as the first set of tires on newly acquired qualifying vehicles meet the definition of "original tires" as that term is defined in section 3.02 of Rev. Proc. 2002-27. Retread tires exchanged for original or replacement tires on qualifying vehicles meet the definition of "replacement tires" as that term is defined in section 3.03 of Rev. Proc. 2002-27. Accordingly, retread tires acquired as "original tires" or "replacement tires" should be treated as such by taxpayers that have elected to account for the costs of original tires and replacement tires for all of their qualifying vehicles under the OTC method.

Conclusions

1. A taxpayer who has not elected to account for the cost of original tires and replacement tires for all of its qualifying vehicles under the OTC method should capitalize the cost of retread tires used as the original or replacement set of tires on newly acquired tractors, trailers and/or trucks as an improvement cost if the retread process appreciably prolongs the tires' original useful lives or materially increases their value. Otherwise, the taxpayer should deduct this cost as a repair cost.

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2. A taxpayer who has elected to account for the cost of original tires and replacement tires for all of its qualifying vehicles under the OTC method should treat retread tires acquired as the first set of tires on newly-acquired qualifying vehicles as "original tires" as that term is defined in section 3.02 of Rev. Proc. 2002-27.

3. A taxpayer who has elected to account for the cost of original tires and replacement tires for all of its qualifying vehicles under the OTC method should treat retread tires that have been exchanged for original or replacement tires on qualifying vehicles as "replacement tires" as that term is defined in section 3.03 of Rev. Proc. 2002-27.

If you have any questions on this matter, contact Charles Magee at (202) 622-3110.

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