**INTERNAL REVENUE SERVICE**
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

August 22, 2001

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CASE MIS No.: TAM-109615-01/CC:ITA:B3

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

ISSUE:

Whether amounts incurred by Taxpayer for garments, linens, shop towels, continuous roll towels, and mops having useful lives of 12 months or less may be deducted currently under § 162 of the Internal Revenue Code or must such amounts be capitalized under § 263.

CONCLUSION:

Amounts incurred by Taxpayer for garments, linens, shop towels, continuous roll towels, and mops having useful lives of 12 months or less may be deducted currently under § 162 in accordance with Rev. Rul. 69-81, 1969-1 C.B. 137, and Rev. Rul. 78-382, 1978-2 C.B. 111.

FACTS:

Taxpayer is a group of affiliated corporations that computes its income for federal income tax purposes using an accrual method of accounting and a fiscal tax year. Taxpayer is engaged in business as an industrial laundry. This business consists, in part, of leasing and cleaning many products including garments, linens, shop towels, continuous roll towels and mops (the "rental items").

Most customers lease, rather than buy, the items that Taxpayer picks up, cleans, and delivers back to the customer. Taxpayer manufactures some of its standard garments. However, these garments represent less than one half of the total company needs. The remaining items are purchased by Taxpayer from outside vendors. Taxpayer maintains a supply of rental items on hand to replace worn or damaged items. Replacement of such items is a constant and continuous process. Taxpayer also keeps a supply of rental items on hand for new customers. Taxpayer places these items into service only as they are needed. Once new rental items are placed into service, Taxpayer can not track individual items. Only for purposes of this request for technical advice and the years at issue herein, the Taxpayer and revenue agent have agreed that the rental items have useful lives of 12 months or less.

For financial accounting purposes, Taxpayer pools the rental items placed into service each month and amortizes the cost of the pool over time based on the type of product in each pool. The amortization periods for financial accounting purposes are as follows:

| **Inventory Type** | **Book Period** |
|---|---|
| **Garments** | 12 months |
| **Linens** | 12 months |
| **Shop Towels** | 9 months |
| **Continuous Roll Towels** | 12 months |
| **Mops** | 12 months |

This method of accounting conforms with Generally Accepted Accounting Principles and is used by Taxpayer for its published financial statements, its annual report, and its reports to the Securities and Exchange Commission. Taxpayer indicates that this method is used for financial accounting purposes because it eliminates short-term fluctuations in merchandise expense thereby resulting in more predictable financial results. Taxpayer explains that this predictability is important to a public corporation that reports earnings on a quarterly basis.

For federal income tax purposes, Taxpayer deducts the costs of the rental items as business expenses during the taxable year that the rental items are placed in service. Taxpayer has followed this method of accounting for tax purposes for at least 25 years. According to the taxpayer, this method of accounting for federal income tax purposes is consistent with or more conservative than industry practice.

<u>LAW AND ANALYSIS</u>:

The issue in this case is whether amounts incurred by Taxpayer for rental items having useful lives of 12 months or less, may be deducted under § 162 or whether such amounts must be capitalized under § 263. Taxpayer asserts that, in accordance with Rev. Rul. 69-81, 1969-1 C.B. 137, and Rev. Rul. 78-382, 1978-2 C.B. 111, these amounts may be deducted as the rental items are placed in service. In contrast, the revenue agent argues that the amounts at issue should be capitalized under § 263 because they provide benefits extending substantially beyond the close of the taxable year and because capitalization is necessary to clearly reflect taxpayer's income. For the reasons described below, we believe the amounts at issue in this case may be deducted in accordance with Rev. Rul. 69-81 and Rev. Rul. 78-382.

## I. Capitalization

Sections 162 and 1.162-1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Among the items included in business expenses are supplies used in the taxpayer's trade or business. See § 1.162-1(a).

Section 1.162-3 provides that taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year. If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to include in his expenses and to deduct from gross income the total cost of such supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

Nevertheless, § 263 prohibits deductions for capital expenditures. Section 263(a) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. See also § 1.263(1)-1(a).

Section 1.263(a)-2(a) provides that 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.

In Rev. Rul. 69-81, 1969-1 C.B. 137, the Internal Revenue Service specifically addressed the treatment of expenses incurred by an industrial laundry engaged in the rental service of shop towels, garments, gloves, linens, and business shirts having a useful life to the taxpayer of "one year or less." The taxpayer maintained a supply of these items and put them in service only as actually needed in their business. The taxpayer, who used the accrual method of accounting, charged the costs of the rental items to expense when the items were placed in service. Based on these facts, the

Service concluded that the taxpayer's treatment of these items was an acceptable method of accounting for federal income tax purposes.

In Rev. Rul. 78-382, 1978-2 C.B. 111, the Service examined whether § 1.162-3 applied to require a cash method taxpayer to defer its deduction for amounts paid to purchase rental uniforms until the taxable year the uniforms were placed in service. The taxpayer was a corporation engaged in the business of supplying, servicing, laundering and repairing uniforms for industrial and commercial establishments on a rental contract basis. The useful life of the uniforms varied, but most uniforms did not remain in use for 12 months. The Service explained that the purpose of § 1.162-3 was to prevent the current deduction upon acquisition of or payment for materials and supplies that are not held for sale and are therefore not inventoriable. The Service further reasoned that this regulation provides no indication that a taxpayer using one method of accounting should be treated differently from a taxpayer using another method of accounting. Thus, the Service concluded that § 1.162-3 applies to taxpayers using either the cash or the accrual method of accounting, and that the taxpayer described in the revenue ruling must deduct the costs of the uniforms in the taxable year that the uniforms are placed in service.

In the present case, Taxpayer's facts are analogous to those provided in Rev. Rul. 69-81 and are similar to those provided in Rev. Rul. 78-382. In particular, Taxpayer is engaged in the industrial laundry business, which involves the leasing and cleaning of certain garments, linens, shop towels, continuous roll towels, and mops. As in both revenue rulings, the rental items at issue in Taxpayer's case have useful lives of 12 months or less. Furthermore, as in Rev. Rul. 69-81, Taxpayer uses the accrual method of accounting and deducts the costs of the items as they are placed in service. Because Rev. Rul. 69-81 and Rev. Rul. 78-382 specifically allow taxpayers under these particular facts and circumstances to deduct the costs of these rental items in the taxable year that they are placed in service, Taxpayer in this case is not required to capitalize the costs of these items under § 263(a).

Moreover, these revenue rulings provide a narrow exception to the general rule set out most recently in USFreightways Corp. v. Commissioner, 113 T.C. 329 (1999), wherein the court held that the taxpayer could not currently deduct the cost of licenses and insurance even though the licenses and insurance policies all had effective periods of 12 months or less. In that case, the court rejected a rule which would permit a "near-automatic deduction for costs relating to benefits lasting less than one 12-month period." Id. at 335. Instead, the court indicated that the determination of whether an amount must be capitalized "rests upon whether the life of the contested benefit exceeds the tax year in which it is incurred, not whether it endures beyond one 12-month period." Id. However, because Rev. Rul. 69-81 and Rev. Rul. 78-382 specifically sanction Taxpayer's method of deducting the costs of the rental items at issue during the taxable year they are placed in service and these revenue rulings were effective during the tax years at issue, Taxpayer is not required to capitalize the amounts at issue under USFreightways and § 263(a).

## II. Clear Reflection of Income

As an alternative reason for requiring Taxpayer to capitalize the amounts at issue in this case, the revenue agent asserts that capitalization is required to clearly reflect Taxpayer's income within the meaning of § 446. Specifically, the revenue agent emphasizes that Taxpayer's method of deducting the costs of rental items in the taxable year such items are placed in service does not conform to Generally Accepted Accounting Principles ("GAAP"). In contrast, the revenue agent notes that Taxpayer's method of accounting for book purposes, i.e., amortizing the costs of the rental items over their estimated useful lives, is consistent with GAAP. Moreover, the revenue agent argues that Taxpayer's method of accounting for tax purposes reflects a volatility in month to month activity that distorts income and generates substantially different results than Taxpayer's method of accounting for financial accounting purposes. The revenue agent contends that Taxpayer's method of accounting for financial accounting purposes results in a smoother recognition of expense, and therefore, a clearer reflection of income. Taxpayer argues that capitalization is not required as Taxpayer is already using an acceptable method of accounting. For the reasons described below, we believe the clear reflection of income principles of § 446 do not require capitalization in this case.

Section 446(a) provides the general rule that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books. See also § 1.446-1(a)(1).

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used 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. See also §§ 1.446-1(a)(2) and 1.446-1(c)(1)(ii)(C).

Section 1.446-1(a)(2) provides in part that a method of accounting that reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expenses are treated consistently from year to year.

Section 1.446-1(c)(1)(ii)(C) provides that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations.

The Commissioner is vested with broad discretion in determining whether a particular method of accounting employed by a taxpayer clearly reflects the taxpayer's income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979). However, he cannot require a taxpayer to change from an accounting method that clearly reflects income to an alternate method that more clearly reflects income. Molsen v. Commissioner, 85 T.C. 485, 498 (1985); Peninsula Steel Products & Equip. v. Commissioner, 78 T.C. 1029, 1045 (1982). Whether a taxpayer's method of accounting clearly reflects income is a question of fact to be determined on a case-by-case basis. Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. 367, 371 (1995). In general, however, a method of accounting clearly reflects income when it results in accurately reported taxable income under a recognized method of accounting. RLC Industries Co. v. Commissioner, 98 T.C. 457, 490 (1992).

Many cases have held that a taxpayer's method of accounting clearly reflected the taxpayer's income where the taxpayer utilized a method of accounting provided in the Code, the regulations, a revenue ruling, or a revenue procedure. See, e.g., United States v. Hughes Properties, 476 U.S. 593 (1986); Frysinger v. Commissioner, 645 F.2d 523 (5th Cir. 1981); Barnett Banks of Florida, Inc. v. Commissioner, 106 T.C. 103 (1996); RLC Industries Co., 98 T.C. 457; Packard v. Commissioner, 85 T.C. 397 (1985); Van Raden v. Commissioner, 71 T.C. 1083 (1979), aff'd, 650 F.2d 1046 (9th Cir. 1981); Galedrige Construction, Inc. v. Commissioner, T.C. Memo. 1997-240; Hospital Corp. of America v. Commissioner, T.C. Memo. 1996-105. In these cases, the courts noted that (1) the taxpayer did not manipulate the method of accounting, (2) the taxpayer did not have a tax avoidance purpose in utilizing the method of accounting, or (3) the taxpayer's method did not result in a purposeful or material distortion of income.

Although a taxpayer's method of accounting may be in compliance with the Code or regulations, it is still subject to the clear reflection of income standard. See, e.g., Hughes Properties, 476 U.S. 593; Ford Motor Co. v. Commissioner, 71 F.3d 209 (6th Cir. 1995). For example, in Ford Motor Co. v. Commissioner, the court rejected the taxpayer's use of an acceptable method of accounting because it did not clearly reflect income. In this case, the taxpayer, an accrual basis taxpayer, settled numerous tort claims by entering into structured settlement agreements with the tort claimants. Under the terms of the settlement agreements, the taxpayer was to make annuity payments to the each of the tort claimants over differing periods, the longest of which was 58 years. In order to fund these payments, the taxpayer purchased single premium annuity contracts during 1980. The taxpayer then claimed a deduction for its 1980 taxable year for the entire amount of all future payments it was required to make to all tort claimants in satisfaction of the settlement agreements. The Sixth Circuit held that, even though the taxpayer's deduction was in compliance with the regulations under § 461, its method of accounting for tax purposes did not clearly reflect income. Specifically, the court was concerned that allowing the taxpayer a full deduction in 1980 could result in the tax benefit derived from the deduction funding the full amounts due in future periods, leaving the taxpayer with a profit. Accordingly, the court denied the deduction on the grounds that the economic results of the transactions were grossly different from the tax results.

Beyond compliance with the Code and regulations, courts have identified other factors in determining whether a method of accounting clearly reflects income, including the following: (1) Whether the taxpayer consistently used its method of accounting; see, e.g., Ansley-Sheppard-Burgess Co., 104 T.C. at 375 and Molsen, 85 T.C. at 506; (2) Whether taxpayer's method of accounting conforms to the industry practice; see, e.g., Molsen, 85 T.C. at 506; and (3) Whether the taxpayer made an attempt to unreasonably prepay expenses or defer the recognition of income (i.e., whether the taxpayer made an attempt to manipulate the method of accounting); see, e.g., Ansley-Sheppard-Burgess Co., 104 T.C. at 375.

Although compliance with Generally Accepted Accounting Principles (GAAP) is another important consideration in determining whether a taxpayer's method of accounting clearly reflects income, the Supreme Court has rejected the notion that there is a "presumptive equivalency" between tax and financial accounting methods. See Thor Power Tool Co. v. Commissioner, 439 U.S. at 544. In Thor Power Tool Co., the Court noted that financial accounting and tax accounting have very different objectives. The primary purpose of financial accounting is to provide useful and accurate information to management, shareholders, creditors, and other interested parties. Accordingly, financial accounting is based on the principle of conservatism. In contrast, the principal purpose of tax accounting is the equitable collection of revenue and the protection of the public fisc. Thus, a method of accounting may be acceptable for income tax purposes even though it is not in accordance with GAAP and it is not used by the taxpayer for its financial statements and reports. See, e.g., Rev. Rul. 80-308, 1980-2 C.B. 162 (utility may deduct increased fuel costs in year fuel is delivered to customers even though, for financial purposes, the costs are deferred until the utility includes increased charges in its customer's bills); Rev. Rul. 75-407, 1975-2 C.B. 196 (utility was required to currently deduct the cost of fuel oil used to generate electricity even though part of the cost was deferred for financial reporting purposes); Rev. Rul. 68-83, 1968-1 C.B. 190 (bank could file tax returns on cash method of accounting and use accrual method for financial purposes).

In the instant case, we believe that Taxpayer's method of accounting for the costs of its rental items having useful lives of 12 months or less does not violate the clear reflection of income principles of § 446. First, Taxpayer's method of deducting these costs in the taxable year these items are placed in service is consistent with Rev. Rul. 69-81 and Rev. Rul. 78-382. In fact, Rev. Rul. 69-81 specifically provides that this method constitutes an acceptable method of accounting for federal income tax purposes. Second, we are not persuaded that, regardless of Taxpayer's compliance with published rulings, the use of this method results in a distortion of income or substantial disparity of economic results that would mandate a change in Taxpayer's method. See, e.g., Ford Motor Co., 71 F.3d 209. Finally, Taxpayer has consistently used this method of accounting for more than 25 years, and this method conforms to or is more conservative than industry practice for tax accounting purposes. As discussed above, the Commissioner cannot require a taxpayer to change from a method that clearly reflects income to an alternate method of accounting that more clearly reflects income, even where the method being challenged is not in compliance with GAAP. Therefore, in this case, the clear reflection of income principles of § 446 do not require capitalization of amounts incurred by Taxpayer for rental items having useful lives of 12 months or less.

CAVEAT:

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.