DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Losses on Certain Tangible Property, Software, Subscriber Membership Base, Assembled Workforce.

This Field Service Advice responds to your memorandum, dated July 19, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Corp X =
Corp Y =
Corp Z =
M =
Insurance A =
Insurance B =
Insurance C =
State A =
Year 0 =
Year 7 =
Firm A =
Firm B =
Tax Year 1 =
Tax Year 2 =
Tax Period X =
Software X =

Percent A	=
$A	=
$B	=
$C	=
$D	=
Line A	=
Line B	=
Line C	=
Line D	=
Entity A	=

ISSUES:

1. Whether petitioner properly claimed losses with regard to subscriber-based intangible and assembled workforce.

2. Whether petitioner properly claimed losses with respect to computer software.

3. Whether petitioner properly claimed losses with regard to certain tangible assets.

CONCLUSIONS:

1. Petitioner may not deduct claimed losses under section 165 with regard to either their subscriber-based intangible and assembled workforce. In addition, petitioner is attempting to change its method of accounting without the permission of the Commissioner.

2. Petitioner may not deduct the claimed losses under I.R.C. § 165 with respect to computer software.

3. Petitioner may not claim losses with regard to certain tangible assets.

FACTS:

Petitioner, Corp X, is an M entity subject to regulation in State A to provide Insurance A and related services. Corp X uses the accrual method of accounting and a calendar taxable year. Corp Y (collectively with Corp X, the petitioners) is a wholly owned subsidiary of petitioner and has been taxable since its inception. Corp Y provides Insurance B as well as insurance coverage similar to Corp X, except that it does not provide Insurance C.

Corp X and Corp Y merged into Corp Z in Year 7. The taxpayers offer group policies to employers and individual policies to individuals. In addition, they provide administrative services to certain other types of medical programs, such as Medicare.

Corp X was formerly a tax exempt entity under section 501(c)(3), as were other M entities. In 1986, Congress ended the tax exemption for M entities for years starting after December 31, 1986 in the Tax Reform Act of 1986 (the Act). To ease the transition to taxable status, Congress adopted several transitional rules in § 1012(c)(3) of the Act. Specifically, Act § 1012(c)(3)(A)(ii) provides that, for purposes of determining gain or loss, the adjusted basis of assets for M entities is equal to fair market value as of the first day of their first taxable year after December 31, 1986, the date of conversion.

To determine its FMV "stepped-up basis" under the transitional rule, petitioner hired two outside valuation firms to value certain of petitioner's tangible and intangible assets. The valuation firms hired by petitioner are Firm A, who valued petitioner's tangible assets, and Firm B, who valued petitioner's intangible assets (i.e., subscriber membership base, assembled workforce and Software X). Based on these valuations and other computations performed by petitioner in connection with such valuations, petitioner claims that it is entitled to additional loss deductions attributable to the sale, retirement, abandonment, termination or worthlessness of certain of its tangible assets, subscriber membership base, assembled workforce and Software X under section 165.

For the first time in its First Amended Petition, petitioner claimed that it is entitled to deduct losses during Tax Years 1 and 2 attributable to the sale, retirement, abandonment, termination or worthlessness of certain of its tangible and intangible assets. Petitioner did not claim similar abandonment loss deductions on its Federal income tax returns for Tax Period X.

With respect to the cost basis of the intangible assets in this case, petitioner did not capitalize the expenses incurred in connection with the intangible assets. The basis of such assets for purposes of petitioner's financial statements and Annual Statements to the State A was zero.

Subscriber Membership Base

Subscribers are the individuals and employers contracting with petitioner for health insurance or other related services. Petitioner's subscriber membership base on January 1, 1987 consisted of thousands of group contracts within the following 4 lines of business: Line A, Line B, Line C and Line D.

Firm B performed a valuation of petitioner's subscriber membership base intangible as of January 1, 1987. Firm B did not calculate the amount of petitioner's claimed subscriber base abandonment loss deductions for Tax Years 1 and 2. Petitioner calculated its claimed subscriber base abandonment loss deductions for Tax Years

1 and 2 based on the "per individual member" fair market value for each of the four lines of businesses as determined by Firm B.

Firm B’s subscriber valuation report uses an "income approach" for its valuation. Firm B estimated the attrition rate of petitioner’s existing total membership base in the aggregate on January 1, 1987, and forecasted the net cash flows from the projected declining number of members for all of the medical insurance product lines in the aggregate offered by petitioner. To determine the rate at which petitioner’s subscribers terminate, Firm B allegedly performed a study of the attrition rate for all of petitioner’s subscribers in the aggregate. A present value was calculated based on the discounted net cash flows using a Percent A discount rate. The discount rate of Percent A is allegedly derived from petitioner’s weighted average cost of capital.

This and other assumptions lead to a subscriber membership "net cash flow" FMV as of January 1, 1987, in the aggregate amount of $A. Firm B did not take into account the ages or life expectancies of any of petitioner’s individual subscribers; thus, Firm B did not perform a "lifing study" of petitioner’s subscriber membership base.

Second, Firm B’s report allocated the $A aggregate subscriber membership base FMV among the 4 lines of the membership base in proportion to each line's forecasted contribution to total gross margin. Finally, the "gross margin" values allocated to each of the 4 lines were then divided by the total number of members in each of the 4 lines, to arrive at a value for each of the 4 lines of the membership base in terms of an "average value per individual member" as of January 1, 1987. No detailed valuations were done on a per individual or per contract basis.

Petitioner's claimed subscriber membership base partial abandonment loss deductions for Tax Years 1 and 2 stem from the reduction in members with respect to petitioner's canceled group contracts in Lines 3 and 4 only. Petitioner did not claim any abandonment losses in Tax Years 1 and 2 with respect to Lines 1 and 2 because those contracts were not canceled during Tax Years 1 and 2. The terminations of petitioner's subscribers during Tax Years 1 and 2 allegedly resulted from normal and routine cancellations and nonrenewals. That is, employers dropped petitioner's "group contract" plans, lost coverage because of nonpayment of premiums or changed plans. We understand that the group contract terminations were not the result of petitioner's withdrawal from a line of business or the cancellation of a plan type or insurance product.

The partial subscriber base abandonment loss deductions calculated and claimed by petitioner for Tax Years 1 and 2 are the product of the number of individual members within the alleged canceled group contracts for Lines 3 and 4 multiplied by the "average per member" value of group subscribers within the Lines 3 and 4 as determined by Firm B. Petitioner has not been able to determine the extent, if any, to which groups or individuals within those groups that terminated their coverage in Tax Years 1 or 2 subsequently became a customer of petitioner again.

Assembled Workforce

Firm B valued petitioner's assembled workforce intangible as of January 1, 1987, in a report. The report uses a "cost to replace" method to value petitioner's assembled workforce. Firm B's report indicates that a cost to replace is based on estimates of costs to recruit, train and relocate a replacement workforce. Outside recruitment costs, training costs, costs of interviewing and recruiting time were estimated for four categories of employees: executive, management, professional and clerical/technical. Relocation costs were estimated for the executive category of employee only.

Firm B did not apply an "obsolescence factor" to the estimated cost to replace petitioner's assembled workforce. Firm B's report places a FMV of $B on petitioner's assembled workforce in place as of January 1, 1987, and determines a per employee replacement cost for each one of the 4 categories of employees. No value per individual employee was calculated.

The partial assembled workforce abandonment loss deductions calculated and claimed by petitioner for Tax Years 1 and 2 are the product of the number of employees from each category who were hired prior to January 1, 1987 and who allegedly left petitioner's workforce during Tax Years 1 and 2 multiplied by the estimated per employee replacement cost for each category as determined by Firm B. Petitioner is including employees of Corp Y within its valuation of, and alleged partial abandonment of, its assembled workforce.

Software X

Petitioner's Software X is a combined Medicare Part A and B claims system. Medicare Part A deals with settling hospital claims, while Medicare Part B deals with physician claims. According to petitioner, Year A, the Health Care Financing Administration (HCFA) required petitioner to begin using certain "standard" software systems. As a result, petitioner claims that in Year 0 it began testing how to remove Part A claims from Software X, and in Year B, converted to a new system for processing Part A claims. According to petitioner, the conversion from Software X, Part A to the new Part A occurred over a weekend in Tax Year 1. Petitioner claims that the Software X Part A system was not used after Tax Year 1.

Petitioner claims that the Part B system of Software X was converted in the same manner as the Part A system of Software X on the last weekend in Tax Year 1. Petitioner claims that Software X was not used after Tax Year 1, because it was completely replaced in Tax Year 2 with a new Part B claims processing system.

HCFA funded, paid for or reimbursed petitioner for all, or at least a substantial portion, of petitioner’s costs for converting from Software X Part A and Part B to the new Part A and Part B. Petitioner received the Part A and Part B conversion funding, payment or reimbursement from HCFA through petitioner’s submission of "Special Budget Requests" to HCFA. HCFA paid at least $C to petitioner during Tax Year 1 and 2 for petitioner’s Medicare Part A and Part B software system conversion costs.

Firm B valued petitioner’s Software X intangible as of January 1, 1987, in two separate reports. The second report valued Software X at $D. Both reports use a "cost to replace" method to value petitioner’s Software X.

There also exists a question as to whether petitioner actually owned the Software X in fee simple on January 1, 1987, or whether petitioner merely had a perpetual nonexclusive license agreement with Entity A to use the Software X. Entity A developed, maintained and enhanced many of the software systems utilized by petitioner during the early 1980s.

Tangible Assets

The valuation report provides what is asserted to be the fair market value of certain of petitioner’s tangible assets as of January 1, 1987. It lists over 7,000 separate tangible assets. The types of tangible assets valued in the Firm A report include petitioner’s leasehold improvements, electronic data processing equipment, copiers, office furniture, fixtures and equipment, cleaning equipment (e.g., vacuum cleaners), communications equipment, security systems and motor vehicles.

LAW AND ANALYSIS:

Background

Petitioners were formerly tax exempt entities under section 501(c)(3), as were other Blue Cross Blue Shield entities. In 1986, Congress ended the tax exemption for Blue Cross Blue Shield entities for years starting after December 31, 1986 in the Tax Reform Act of 1986 (the Act).

Section 1012(a) of the Act revoked the tax-exempt status of certain medical insurers and made the entities taxable under I.R.C. § 833 as if they were stock insurance companies.

Under section 1012(c)(3)(A)(ii) of the Act, the entities receive an adjusted basis in their assets equal to their fair market value as of January 1, 1987, for purposes of determining gain or loss.

The legislative history of section 1012(c)(3)(A)(ii) of the Act states that the fair market value basis adjustment is provided solely for the purpose of determining gain or loss on the sale or exchange of assets and not for depreciation or other purposes. The Conference Report clarifies that the basis adjustment was provided because the conferees believed that the formerly tax-exempt organizations should not be taxed on unrealized appreciation or depreciation that accrued during the period the organization was not generally subject to income taxation. 2 H.R. Conf. Rept. 841, 99th Cong., 2d Sess. II-350 (1986); see also Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. 591 (1987).

Section 165 Loss

Abandonment losses are deductible under I.R.C. § 165(a), which allows any loss sustained during the taxable year and not compensated for by insurance or otherwise.

The first issue is whether any abandonment loss can be claimed on property valued at fair market under section 1012 of the Act given that the legislative history arguably limits the basis adjustment to the "sale or exchange" of assets. That is, an abandonment is not a sale or exchange. See Citron v. Commissioner, 97 T.C. 200, 213-14 (1991); Equity Planning Corp. v. Commissioner, T.C. Memo. 1983-57. It is the position of the Office of Chief Counsel that the basis provided under section 1012(c) of the Act should be used for computing losses under section 165 incurred by taxpayers subject to section 1012(a) of the Act. Although it may not be cited as precedent, this position is embodied in LTR 9533003.

The requirements for an abandonment loss are found in the regulations under section 165. Specifically, Treas. Reg. § 1.165-2(a) allows a loss incurred in a business and arising from the sudden termination of the usefulness of any nondepreciable property, in a case where the business is discontinued or where the property is permanently discarded from use therein, as a deduction under section 165(a) for the taxable year in which the loss is actually sustained.

Treas. Reg. §1.165-1(b) requires that, to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, and fixed by identifiable events. Normally, an abandonment loss requires (1) an intention on the part of owner to abandon the asset, and (2) an affirmative act of abandonment. A.J. Industries, Inc. v. United States, 503 F.2d 660, 670 (9th Cir. 1974); Citron, 97 T.C. at 209; CRST, Inc. v. Commissioner, 92 T.C. 1249, 1257 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990).

The Fifth Circuit has a special rule which allows a deduction for assets that are worthless that is an independent and separate ground for a deduction under section 165. See Echols v. Commissioner, 935 F.2d 703 (5th Cir. 1991), reh'g denied, 950

F.2d 209 (5th Cir. 1991). Under the worthlessness test set forth in Echols, 935 F.2d at 707, it is determined subjectively when it was that the taxpayers deemed their property to be worthless and then determined objectively whether the interest was valueless at that time.

Subscriber and Assembled Workforce Intangibles

It is clear that intangible assets may be the subject of an abandonment loss. Parmelee Transportation Co. v. United States, 351 F.2d 619 (Ct. Cl. 1965). See Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220 (1959), acq. 1973-2 C.B. 2; Solar Nitrogen Chemicals, Inc. v. Commissioner, T.C. Memo. 1978-486. The central issue in the present case is the resolution of whether subscribers or employees can be abandoned individually; or whether the individual components must be treated as part of an indivisible whole, i.e., the subscriber- based intangible or assembled workforce, which itself is the only proper subject for an abandonment loss.

There have been numerous cases holding that assets indistinguishable from the subscriber-based intangible and assembled workforce involved in the present case are single indivisible assets and not an aggregation of individual assets. Ralph W. Fullerton Company v. United States, 550 F.2d 548 (9th Cir. 1977)(customer list); Sunset Fuel Co. v. United States, 519 F.2d 781 (9th Cir. 1975)(customer list); Skilken v. Commissioner, 420 F.2d 266 (6th Cir. 1969)(contracts for vending machine locations); Meredith Publishing Co. v. Commissioner, 64 F.2d 890 (8th Cir. 1932), cert. denied, 290 U.S. 646 (1933) (magazine subscription list); Golden State Towel and Linen Service, 373 F.2d 938 (Ct. Cl. 1967)(customer list); Ithaca Industries, Inc. v. Commissioner, 97 T.C. 253 (1991), aff'd,17 F.3d 684 (4th Cir.), cert. denied, 513 U.S. 821 (1994)(workforce); Tomlinson v. Commissioner, 58 T.C. 570 (1972), aff'd, 507 F.2d 723 (9th Cir. 1974) (insurance expirations);Hodges v. Commissioner, 50 T.C. 428 (1968), acq. on another issue, 1969-2 C.B. xxiv; Boe v. Commissioner, 35 T.C. 720 (1961), aff'd, 307 F.2d 339 (9th Cir. 1962)(medical service contracts); Thrifticheck Service Corp. v. Commissioner, 33 T.C. 1038 (1960), aff'd, 287 F.2d 1 (2d Cir. 1961)(customer contracts) ; Anchor Cleaning Service v. Commissioner, 22 T.C. 1029 (1954), nonacq. on another issue, 1958-2 C.B. 9 (customer list); Commercial National Insurance Co. v. Commissioner, 12 B.T.A. 655 (1928)(insurance policyholders); Illinois Cereal Mills, Inc. v. Commissioner, T.C. Memo. 1983-469, aff'd, 789 F.2d 1234 (7th Cir.), cert. denied, 479 U.S. 995 (1986) (customer list).

Some of the cases cited directly have held that the loss of an individual component of the indivisible asset could not be separately deducted as a loss. In particular, taxpayers could not deduct amounts attributable to each customer they lost. Fullerton, supra; Sunset Fuel, supra; Golden State Towel, supra; Tomlinson; supra; Hodges, supra; Thrifticheck, supra; Anchor Cleaning, supra; Illinois Cereal Mills, supra; see Skilken supra; Boe, supra.

The facts of the present case are clearly distinguishable from the circumstances where the taxpayer abandons a portion the indivisible asset which has distinct transferrable value that is reasonably severable from the whole. The pivotal case on this issue is Metropolitan Laundry Co. v. United States, 100 F. Supp. 803 (N.D. Cal. 1951), where the taxpayer was permitted an abandonment loss on a portion of a customer list that was attributable to a specific geographic area. The taxpayer had purchased the customer lists of several laundry businesses in San Francisco and Oakland. During World War II, the government seized the taxpayer's San Francisco plant for military purposes. After the war, the taxpayer had trouble reestablishing its business and abandoned its San Francisco routes while it continued its operations in Oakland. The district court recognized that "a list of customers...is not to be regarded as an aggregation of disconnected individual subscribers;" the customer lists were instead treated as "unitary structures irrespective of incidental fluctuations or alterations." Metropolitan Laundry, 100 F. Supp. at 805. The court noted, however, that a taxpayer could "dispose of its business in a particular area or in respect to a particular product or service along with incidental goodwill without abandoning its entire business." Id. at 806. "And...so long as the business and the goodwill disposed of may be assigned a distinct transferable value, the transaction may properly be recognized, for tax purposes, as a closed one." Id. at 806-07. The court found that the costs attributable to the abandoned San Francisco customer lists met this test and were deductible.

Similarly, Massey-Ferguson held that the taxpayer could deduct the costs attributable to the abandonment of a line of business it had purchased from another party and operated at a distinct location, even though the taxpayer continued to manufacture similar products under a different trade name at another location. See also Parmelee Transportation; Strauss v. United States, 199 F. Supp. 845 (W.D. La. 1961). We note that a workforce intangible would be subject to the rationale of Massey-Ferguson.

Petitioners in the present case have not abandoned a segment of their business that is in any way analogous to the facts of either Metropolitan Laundry or Massey-Ferguson. The distinction between the facts similar to the present case and those found in Metropolitan Laundry has been explicitly recognized by the courts. As stated in Golden State Towel, 373 F.2d at 940-41,

> One cannot say that the plaintiff's annual crop of terminated customers had a "distinct transferable value" as did the entire body of San Francisco routes in the Metropolitan Laundry instance, for whereas the one might well have constituted the subject matter for a sale had Metropolitan so wished, it cannot be imagined that the plaintiffs would have been able or desirous of selling to another their right to serve the periodically departing customers. There was no market for a piecemeal sale of customers.

See Skilken, 420 F.2d at 270 (no cessation of business in a geographic area of independent significance); Anchor Cleaning, 22 T.C. at 1033-35 (no abandonment or disposition of any identifiable segment of its business).

So long as the intangible asset is deemed to be a whole rather than the sum of any of its parts, the ability to deduct any part of it as a loss under section 165(a) rests ultimately on whether there has been a recognition event. Under facts like the present case, courts have found that the loss of any individual component only reduces the value of the whole asset. Sunset Fuel, 519 F.2d at 783; Manhattan Co., 50 T.C. at 87; Thrifticheck, 33 T.C. at 1047. The mere diminution in value of property is not enough to establish an abandonment loss. Kraft, Inc. v. United States, 30 Fed. Cl. 739, 785-86 (1994); Lakewood Associates v. Commissioner, 109 T.C. 450, 456 (1997), aff'd in an unpublished opinion, 99-1 USTC ¶ 50,s127 (4th Cir. 1999). See United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398, 401 (1927). A diminution in value fails to satisfy the requirement under the regulations that a loss be "evidenced by closed and completed transactions, fixed by identifiable events." Sunset Fuel, 519 F.2d at 783. See S.S. White Dental, at Id. In addition, no loss is allowed under section 165 for the partial deduction of a capital asset. Golden State Towel, 373 F.2d at 942, citing Anchor Cleaning and Hillside Dairy; Illinois Cereal Mills, supra.

For the same reasons, petitioners will not be able to claim a loss based on worthlessness under the rationale of Echols, because the mass asset is not wholly worthless and a partial deduction of the whole is not allowable. Based upon the above, we conclude that petitioners may not take a deduction under section 165(a) for the loss of individual subscribers or employees lost. The deductions taken by Corp Y should clearly not be taken at fair market value since it is not subject to section 1012(c)(3)(A)(ii) of the Act. Corp Y's intangibles would also be subject to the mass asset rule.

Software X

Because no loss is allowed under section 165 for the partial deduction of a capital asset, Software X must be a separate capital asset in the hands of taxpayer. In this regard, the taxpayer must also own the property on which a loss is claimed. Altmann v. Commissioner, 20 T.C. 236 (1953), vacated and rem'd, 55-2 USTC ¶9599 (2d Cir.); Green v. Commissioner, T.C. Memo. 1982-485.

Further, the intention to abandon, standing alone, is not sufficient to establish a recognition event; instead, there must be an affirmative act of abandonment. See Brandies v. Commissioner, 692 F.2d 152 (1st Cir. 1982), cert. denied, 462 U.S. 1106 (1983); Beus v. Commissioner, 261 F.2d 176, 180 (9th Cir. 1958); Citron, 97 T.C. at 210; Zurn v. Commissioner, T.C. Memo. 1996-386. As a result, there is arguably an inherent requirement for an abandonment loss that the taxpayer, rather than some other party, take the action to abandon permanently the property in question. Further, an abandonment does not result simply from cessation of use. Beus, at Id.; Citron, at Id.

Thus, participation in a government program which required the taxpayer to discontinue his dairy operation, was not an abandonment where there was no showing of the irrevocable intent to abandon or never use the property again. Strandley v. Commissioner, 99 T.C. 259 (1992), aff'd on another issue, 73 AFTR 2d (RIA) 2118 (9th Cir. 1994). Similarly, other cases have held that the actions of another party only affect the value of the property the taxpayer continues to hold. See CRST, 92 T.C. at 1259-61; Consolidated Freight Lines, Inc. v. Commissioner, 37 BTA 576 (1938), aff'd, 101 F.2d 813 (9th Cir. 1939), cert. denied, 308 U.S. 562 (1939); Beatty v. Commissioner, 46 T.C. 835 (1966). As a result, to get an abandonment loss, petitioner must show that it actually acted to abandon Software X in Tax Year 1 and did not simply stop using it.

Besides abandonment, petitioner may show that Software X was worthless in the Tax Year 1 under the test established in Echols. We do not believe petitioner has established worthlessness under Echols.

Further, no loss may be claimed to the extent petitioner has or can be reimbursed. I.R.C. § 165(a); Treas. Reg. § 1.165-1(a) and § 1.165 (d)(2)(i). Here petitioner received reimbursement for the conversion.

The basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property. I.R.C. § 165(b). Petitioner must verify its basis in the property, which it has not done.

Change in Accounting Method - Subscriber and Assembled Workforce Intangibles

We believe petitioners have made an unauthorized change in accounting method because petitioners initially filed federal income tax returns treating the intangible assets at issue as single mass assets. Petitioners must obtain permission to change a method from the Secretary. I.R.C. § 446(e).

The description of what constitutes a method of accounting is found under Treas. Reg. § 1.446-1(e). Initially, there is no question a consistent but erroneous treatment of a material item constitutes a method of accounting. Treas. Reg. § 1.446-1(e)(2)(i). See also Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500, 512 (1989), and the cases cited therein.

In addition, under Treas. Reg. § 1.446-1(e)(2)(ii)(a), a change in method of accounting includes not only a change in the overall plan of accounting, but the treatment of any material item used in the overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item involving the proper time for the inclusion of the item in income or the taking of a deduction. See Hamilton Industries v. Commissioner, 97 T.C. 120, 126 (1991). See also Knight-Ridder Newspapers v. United States, 743 F.2d 781, 798 (11th Cir. 1984).

Service position on the requirements for consistent application of a method is found in Rev. Proc. 90-38, 1990-1 C.B. 57. See Sec. 2.01(2) of Rev. Proc. 97-27, 1997-21 I.R.B. at 11. If a taxpayer treats an item improperly in the first return that reflects the item, the taxpayer must treat the item consistently in two or more taxable years before it has adopted a method. Rev. Rul. 90-38, 1990-1 C.B. at 58. If the treatment is proper, such consistency is not required. Thus, the Supreme Court has held that once a permissible election of a method of accounting has been made, it may not be changed after the time for filing the return has passed. Pacific National Co. v. Welch, 304 U.S. 191 (1938).

We believe the treatment of the assets in the present case is analogous to electing to group assets into general asset accounts under section 168(i)(4) for the purposes of depreciating them as a single asset. Rev. Proc. 97-30, 1997-1 C.B. 702, held that the grouping of assets under section 168(i)(4) was a method of accounting. Whether or not petitioners' proposed treatment is deemed correct, they may not employ the new method of accounting without obtaining consent.

"Retirement Loss" and "Extraordinary Obsolescence Loss" Deductions for Tangible, Depreciable Assets

Cost Recovery Property

If "accelerated cost recovery" property (other than a structural component of a building) is removed from service in a manner that does not constitute a sale, exchange or abandonment (for example, where the property is transferred to a scrap or salvage pile), the taxpayer is entitled to a deduction equal to the excess of the property's unrecovered adjusted tax basis over its scrap or salvage value. See Prop. Treas. Reg. § 1.168-6(a)(3). Because the retirement is not a sale or exchange, the excess of the property's adjusted tax basis over its fair market value is an ordinary loss, and the adjusted basis of the property is reduced to salvage value.

Under the Accelerated Cost Recovery System (ACRS) and the Modified Accelerated Cost Recovery System (MACRS), assets in a mass or general asset account are treated for most purposes as a single asset. Accordingly, no retirement loss is allowed with respect to the retirement of property included in such an account unless all property in the account has been disposed of through sale, exchange, abandonment or retirement. See Prop. Treas. Reg. §§ 1.168-2(h)(1) and 1.168(i)-1(e)(2) & (3)(i). But Cf. Prop. Treas. Reg. § 1.168(i)-1(e)(3)(ii) for an election to recognize a loss on MACRS property included in a general asset account where the disposition occurs in circumstances that would probably qualify as an abandonment rather than a retirement.

Amounts received in payment for assets disposed of from a mass or general asset account (including amounts received for salvage or scrap) must be recognized as income. See Prop. Treas. Reg. §§ 1.168-2(h)(1) and 1.168(i)-1(e)(2)(ii).

The abandonment or retirement of a structural component of a building generally does not constitute a disposition. Accordingly, no loss deduction is allowed on the retirement of such property. The taxpayer continues to recover the cost of such property through ACRS or MACRS deductions. See Prop. Treas. Reg. §§ 1.168-2(l)(1) and 1.168-6(b).

Depreciable Property that is Not ACRS or MACRS Property

The conditions for deducting a retirement loss with respect to property which is not accelerated cost recovery property and is depreciated in a single asset account under I.R.C. § 167 is substantially the same as for accelerated cost recovery property. See Prop. Treas. Reg. § 1.167(a)-1(e)(3)(ii).

Where the property is not in a single asset account a retirement loss is only available if the retirement is an abnormal retirement and the property is not being depreciated under the Asset Depreciation Range system.

Treas. Reg. § 1.167(a)-8(b) defines normal and abnormal retirements as follows:

> [T]he determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in the business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

In order to obtain an abnormal retirement deduction, the taxpayer must show that the asset was withdrawn from service for a reason not contemplated at the time the asset was placed in service, and was withdrawn sooner than expected. An abnormal retirement can also result from "extraordinary obsolescence." See Treas. Reg. § 1.167(a)-8(b). An example of "extraordinary obsolescence" is found in De Cou v. Commissioner, 103 T.C. 80 (1994), where the Tax Court held that a taxpayer's building suffered "extraordinary obsolescence" because, due to the building's extensive structural defects, the governing city authorities in Corpus Christi, Texas refused to grant the health permit that the taxpayer needed to operate the property as a restaurant and topless bar.

Based on the above discussions regarding retirement loss deductions vs. abnormal retirement/obsolescence loss deductions for tangible, depreciable assets, we believe that petitioner is not entitled to the claimed retirement loss deductions for Tax Years 1 and 2 with respect to its tangible assets.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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By: ______________________________
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