



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

OFFICE OF
CHIEF COUNSEL

April 4, 2002

Number: **200228012**
Release Date: 7/12/2002
CC:ITA:5/POSTF-144166-01
UILC: 446.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, PHOENIX
LMSB:NR, AREA 4

FROM: Associate Chief Counsel (Income Tax and Accounting)
CC:ITA

SUBJECT: Accounting For Maintenance Reserves

This Chief Counsel Advice responds to your memorandum dated February 12, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

A =

B =

C =

Equipment =

Equipment X =

Date =

a =

b =

c =

d =
e =

ISSUE

Whether the transferred accumulated maintenance reserves described in the below purchase transaction constitute income to A under A's established method of accounting for maintenance reserves.

CONCLUSION

A's treatment of the transferred accumulated maintenance reserves described in the below purchase transaction¹ constitutes an unauthorized change in A's method of accounting for maintenance reserves. The purchase transaction increased A's maintenance reserve liability by \$e. Under A's existing method of accounting, this increase should have been recognized as taxable income by A.²

FACTS

A is in the business of leasing Equipment. In a typical transaction, A receives monthly rental payments under the lease. A also receives an additional amount from the lessee, described in the leases as "supplemental rent" or "maintenance reserves," which is based on usage of Equipment and certain specific maintenance categories. The maintenance reserves increase monthly and are held by A for the lessee. Generally, as the lessee makes expenditures for required or scheduled maintenance of Equipment, A will reimburse lessee with funds from the maintenance reserve for the amount of the expenditure.

For book purposes, A has historically debited cash and credited Equipment maintenance reserves upon receiving supplemental rent or maintenance reserves

¹ Although A may have entered into numerous leases and/or purchases of Equipment with terms similar to those in the specific transaction addressed here, our conclusion reflects only the specific purchase agreement with B and should be limited to that transaction. It should not be used for, or treated as, a determination with respect to any of A's other transactions.

² Your office has also asked whether a basis adjustment in Equipment X is warranted if the transferred accumulated maintenance reserves do not constitute income to A. Because this office concludes that under A's existing method of accounting, the \$e increase in A's maintenance reserve liability should have been recognized as taxable income by A, we do not reach this basis question.

from a lessee. Upon payment or reimbursement to the lessee for required maintenance, A has debited Equipment maintenance reserves and credited cash.

For income tax purposes, A has historically recorded a Schedule M adjustment, which included all maintenance reserves received from lessees during the tax year in its income. A has generally treated disbursements of such reserves as current period deductions, or capital expenditures.

A generally acquires its Equipment by purchasing used Equipment from sellers. The Equipment is usually under lease from the seller to a third party lessee at the time it is purchased by A. Consequently, A purchases the Equipment subject to the lease to the third party. These leases generally include maintenance reserve provisions similar to those described above. Consequently, A's purchase transactions include either a transfer from the seller to A of the amount of the accumulated maintenance reserve for the Equipment (that is, the amount by which the maintenance reserves received by the seller from the lessee up to the date of sale exceed the cost of repairs and maintenance covered by such reserves), or a credit against the purchase price equal to the amount of the accumulated maintenance reserve.³

Your submission requests Field Service Advice concerning the accumulated maintenance reserves in the following specific transaction. In Date, A purchased Equipment X from B. At the time, Equipment X was subject to a lease from B to C, which required C, as lessee, "at its own cost and expense," to "service, repair, maintain, overhaul, test, or cause the same to be done to the [Equipment X]." In addition, C was responsible under the lease for all routine and non-routine services, checks and inspections.

To ensure that adequate funds would be available to cover the lessee's maintenance and repair responsibilities, the lease established a maintenance reserve to which C paid to B an additional amount each month based upon the actual usage of Equipment X. When C performs, or causes a third party to perform,

³ For example, if, at the time of sale to A, the seller/lessor had received a total of \$1,000,000.00 in maintenance reserves from the lessee under a lease for Equipment, and had disbursed \$800,000.00 of these reserves for covered repairs, the difference of \$200,000.00 would be considered the accumulated maintenance reserves. This \$200,000.00 amount would be transferred with the Equipment to A, as buyer, either as a credit against the purchase price of Equipment or in the form of a separate check. This \$200,000.00 plus subsequent monthly payments of maintenance reserves by the lessee to A, as the successor lessor, would then be held by A and ultimately disbursed by A as the purchased Equipment received covered repairs and maintenance.

“covered maintenance” as defined in the lease, C would submit documentation to B regarding such maintenance. B, as lessor, would then pay C the cost of the covered maintenance from its accumulated maintenance reserve. Under the lease, any amounts paid to the lessor as maintenance reserves which were not used to reimburse the lessee for covered maintenance would be returned to C at the end of the lease with all accrued interest.

A's purchase agreement with B for Equipment X provided for a purchase price of \$a plus transaction costs of \$b. A received certain credits against the purchase price, including a credit of \$c, which is the sum of a \$d security deposit and \$e of accumulated maintenance reserves plus accumulated interest. As indicated above, A acquired Equipment X subject to the terms of the lease to C.

Contrary to its practice regarding maintenance reserves payments received monthly from other lessees under leases for other Equipment, A did not include in its income the \$e in accumulated maintenance reserves plus accumulated interest acquired by virtue of the credit against the purchase price of Equipment X. Instead, A decreased its cost basis in Equipment X by \$e, the amount of the accumulated maintenance reserves plus accumulated interest. Consistent with expenditures for which it has received payments from the lessee or through a transfer from the seller, A currently deducts all expenditures from the transferred maintenance reserves (for which it took a basis adjustment) when due.

You have requested our analysis of whether, under the facts provided in the submission, A must use the same method of accounting for the accumulated maintenance reserves transferred in the purchase agreement with B as A has previously used for amounts received from its Equipment lessees as “supplemental rent” or “maintenance reserves.”

LAW AND ANALYSIS

Section 446(a) of the Internal Revenue Code provides 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. Section 446(e) provides that a taxpayer that changes the method of accounting on the basis of which it regularly computes its income in keeping its books shall, before computing its taxable income under the new method, secure the consent of the Commissioner.

Section 1.446-1(e)(2)(ii)(a) of the Income Tax Regulations provides in part that a change in method of accounting includes a change in the treatment of any material item used in an overall plan of accounting for gross income or deductions. A

material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.

In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which the income is reported, it involves timing and is therefore a method of accounting. See Rev. Proc. 91-31, 1991-1 C.B. 566; Rev. Proc. 97-27, 1997-1 C.B. 680.

The facts presented in the submission demonstrate that A has established a method of accounting for the item variously known as "maintenance reserves" or "supplemental rent." This item represents money held by A, as lessor of Equipment, to secure the performance of required maintenance by the lessee. In accounting terms, the item is a liability of A to the lessee. When the lessee pays maintenance reserves to the A, the liability is increased (credited), and A recognizes taxable income. When A reimburses the lessee for required maintenance, the liability is decreased (debited), and A treats the amount as a deduction or a capital expenditure, as appropriate.

A's treatment of the accumulated maintenance reserves transferred in the purchase agreement with B constitutes an unauthorized change in its method of accounting for maintenance reserves. The purchase increased A's maintenance reserve liability by \$e. Under its existing method of accounting, such increase should have been recognized as taxable income by A. A, however, failed to recognize taxable income; instead, it reduced the basis of the acquired Equipment X by the amount of the increase. This novel accounting practice constitutes a change in method of accounting because it affects (postpones) only the time when income will be recognized, and does not affect the amount of A's lifetime income.

The absence of any cash inflow directly corresponding to the accumulated maintenance reserves transferred in the purchase agreement with B does not distinguish such reserves as a different item from the maintenance reserves resulting from supplemental rentals received by A from its other lessees. In both cases, A's liability to pay for specified maintenance increased by a known amount as a result of valuable consideration received. In one case, the consideration was a purchase price concession that reduced cash outflow; in the other, the consideration consisted of cash inflows. Both forms of consideration had the same net effect: an increase in the A's assets, and a corresponding increase in its liability to lessees to pay for specified maintenance of leased Equipment.

Because A changed its method of accounting for maintenance reserves without obtaining the consent of the Commissioner, the examining agent may change A back to its former method of accounting for such item. Such change should be made in the taxable year that A changed its method without consent, or if that year is closed by the running of the period of limitations, in the earliest open taxable year. The examining agent may impose such change even if A's former method of accounting is impermissible and A's new method of accounting is permissible.⁴ See Rev. Proc. 2002-18, § 2.08, 2002-13 I.R.B. 678, and citations therein.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In our view, A will find it difficult to show that the transferred, accumulated maintenance reserves are a different item for tax accounting purposes such that it can adopt an accounting method different from the method used for the other similar reserves. The primary hazard is that a court could conclude that the maintenance reserves are not income to A, and thus its accounting treatment for the maintenance reserves was an error rather than an accounting method. Therefore, A would not be bound to report the transferred accumulated maintenance reserves as income. A may not want to make this argument because, if the argument succeeds, no deductions would be allowed for the amounts paid out of the reserve. Moreover, if there is no change in accounting method, there will be no section 481 adjustment to prevent the omission of the deductions.

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

Please call if you have any further questions.

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Associate Chief Counsel (Income Tax
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⁴ We express no opinion regarding the propriety of either method.