OFFICE OF
CHIEF COUNSEL

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

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CC:P&SI:6CRamsey
RPAUT-115669-98

MEMORANDUM FOR: Industry Director, Natural Resources (LM:NR)

FROM: CHIEF, BRANCH 6
CC:P&SI:6

SUBJECT: DENIAL OF CONSENT FOR CHANGE IN ACCOUNTING METHOD

In accordance with § 8.07(2)(a) of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 43, this Chief Counsel Advice advises you that consent for a change in accounting method has been denied to a taxpayer within your jurisdiction. Pursuant to § 6110 (k)(3), this Chief Counsel Advice is not to be cited as precedent.

LEGEND:

Taxpayer =

B =

C =

Taxpayer filed the Form 3115 to request permission to change its method of computing depreciation for street lighting equipment under Rev. Proc. 97-37, 1997-2 C. B. 55. Because this change was under an automatic consent revenue procedure, Taxpayer has already made this change.

Taxpayer previously treated equipment used wholly for public street and highway lighting or traffic, fire alarm, police and other signals (collectively, street lighting) as included in asset class 49.14–Electric Utility Transmission and Distribution Plant, under both Rev. Proc. 83-35, 1983-1 C. B. 745, and Rev. Proc. 87-56, 1987-2 C. B. 674. Taxpayer believes this classification was improper. Specifically, Taxpayer believes that this property does not belong in asset class 49.14 or any other class.

The method changes would have been effective with the taxable year beginning B and would have resulted in a negative § 481(a) adjustment/decrease in taxable income in

excess of C. The reasons for denial of this consent are explained in the attached copy of our letter to Taxpayer.

Taxpayer has changed to an impermissible method of accounting. This change is outside the scope of Appendix § 2.01 of Rev. Proc. 97-37 because Taxpayer did not change to a permissible method of accounting. Accordingly, consent to make this change is not granted. Taxpayer should file amended returns for the year of change and subsequent years to reflect the correct method of depreciating street lighting.

If you have any questions on this matter, do not hesitate to call me at (202) 622-3110.

CHARLES B. RAMSEY
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures
copy of letter to Taxpayer

INTERNAL REVENUE SERVICE

Department of the Treasury

Washington, DC 20224

Index Number: 168.20-00
446.04-17

Person to Contact:

Telephone Number:
(202) 622-3110

Refer Reply To:
CC:PSI:6-RPAUT-115669-98

Date:
June 20, 2000

Taxpayer =

Commission =

State =
X =
W =
Y =

Re: Request for Automatic Change in Method of Accounting

Dear :

This letter responds to a Form 3115, Application for Change in Accounting Method, received W, and subsequent correspondence, filed for Taxpayer. Taxpayer seeks permission to change its method of computing depreciation for certain depreciable property, beginning with the taxable year beginning X ("year of change"). This application was filed under §2.01 of the Appendix of Rev. Proc. 97-37.

Taxpayer indicated that the application was filed under the 90-day window–the first 90 days of the tax year, but the application was not dated and not received until W, almost one year after the application should have been filed. In addition, Taxpayer failed to include the separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge the same method of accounting was not an issue under consideration or an issue placed in suspense by the examining agent(s). See § 6.03(2) of Rev. Proc. 97-37.

Taxpayer represents that the facts are as follows:

Taxpayer is subject to regulation by Commission in State. In the years 1981 through 1996 Taxpayer has considered equipment used wholly for public street and highway lighting or traffic, fire alarm, police and other signals (collectively, street lighting) to be included in asset class 49.14–Electric Utility Transmission and Distribution Plant, under both Rev. Proc. 83-35,1983-1 C. B. 745, and Rev. Proc. 87-56, 1987-2 C. B. 674. Taxpayer believes this classification was improper. Specifically, Taxpayer believes that this property does not belong in asset class 49.14 or any other class. For MACRS Property[1] Taxpayer requests permission to depreciate this property as property described in § 168(e)(3)(C)(ii) of the Internal Revenue Code, that is, property that does not have a class life and is not otherwise classified under § 168(e)(2) or (3). For property subject to former § 168 (ACRS Property), Taxpayer requests permission to depreciate this property as 5-year property, that is, § 1245 property that is not 3-year property, 10-year property, or 15-year public utility property (see former § 168(c)(2)(B)). Taxpayer proposed to depreciate the property using a 7-year recovery period and the 200% declining balance method for MACRS property and using a 5-year recovery period for ACRS property. The proposed net negative § 481 adjustment is Y.

Under a 1997 law of State, a municipality may acquire all or any part of the street lighting equipment located within a municipality and owned by an electric company. When a municipality chooses to purchase street lighting equipment, it is necessary to unbundle current street lighting rates by separating the costs of distribution service from the costs of street lighting and to develop an alternate street lighting rate. Commission requires that Taxpayer adhere to the Federal Energy Regulatory Commission (FERC) System of Accounts. The costs for street lighting are included in FERC Account 373, Streetlighting and Signal Systems, which includes the costs of installed equipment used wholly for public street and highway lighting or traffic, fire alarm, police and other signal systems.

In its Form 3115 Taxpayer requests permission to change from its present method of accounting to the requested method of accounting beginning with the year of change.

Law and Analysis

The issue is whether Taxpayer's requested method of depreciating street lighting subject to its Form 3115 is a permissible method of accounting for depreciation of this property under former § 168 (ACRS) or § 168 (MACRS).

Former § 168 (ACRS) generally applies to recovery property placed in service after 1980 and before 1987. The term "recovery property" is defined in former

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[1]MACRS and ACRS are discussed below.

§ 168(c)(1) as meaning tangible property of a character subject to the allowance for depreciation that is used in a trade or business or held for the production of income.

Pursuant to former § 168(c)(2), each item of recovery property is assigned to one class of property specified in former § 168(c)(2). The term “5-year property” is defined in former § 168(c)(2)(B) as meaning recovery property that is § 1245 class property and that is not 3-year property, 10-year property, or 15-year public utility property. The classification of recovery property as 3-year property, 10-year property, or 15-year public utility property is made with reference to the property’s present class life. The present class lives of recovery property for purposes of former § 168 are set forth in Rev. Proc. 83-35.

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 (MACRS property) generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in § 168(a) and the other method is the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of the general depreciation system, the depreciation method, recovery period, and convention are determined by the property's classification under § 168(e). Pursuant to § 168(e)(1), property with a class life of 4 years or less is classified as 3-year property, property with a class life of more than 4 years but less than 10 years is classified as 5-year property, property with a class life of 10 years or more but less than 16 years is classified as 7-year property, property with a class life of 16 years or more but less than 20 years is classified as 10-year property, property with a class life of 20 years or more but less than 25 years is classified as 15-year property, and property with a class life of 25 years or more is classified as 20-year property.

The term "class life" is defined in § 168(i)(1) as meaning the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under § 167(m) (determined without regard to § 167(m)(4) and as if the taxpayer had made an election under § 167(m)) as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990. Former § 167(m) provided that for a taxpayer who elected the asset depreciation range (ADR) system of depreciation, the depreciation allowance was based on the class life prescribed by the Secretary that reasonably reflected the anticipated useful life of that class of property to the industry or other group. Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations provides rules for classifying property under former § 167(m). Under § 1.167(a)-11(b)(4)(iii)(b) property shall be classified according to primary use even though the activity in which such property is primarily used is insubstantial in relation to all the taxpayer’s activity. The present class lives of recovery property for purposes of § 168 are set forth in Rev. Proc. 87-56.

Under the general depreciation system of § 168(a), the depreciation method, recovery period, and convention are prescribed in, respectively, § 168(b), (c), and (d). For 5-year property, the depreciation method and recovery period generally are the 200-percent declining balance method of depreciation and a 5-year recovery period pursuant to, respectively, § 168(b)(1) and (c). For 7-year property, the depreciation method and recovery period generally is the 200-percent declining balance method of depreciation and a 7-year recovery period pursuant to, respectively, § 168(b)(1) and (c). For 15-year property, the depreciation method and recovery period generally is the 150-percent declining balance method of depreciation and a 15-year recovery period pursuant to, respectively, § 168(b)(2) and (c). The applicable convention for 5-year, 7-year, and 15-year property is the half-year convention or the mid-quarter convention, as determined under § 168(d).

Rev. Proc. 87-56 and Rev. Proc. 83-35 divide assets into two broad categories: (1) asset classes 00.11 through 00.4 that consist of specific depreciable assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of depreciable assets used in specific business activities. The asset class lives described in these revenue procedures are based on a system of classification that was first described in Rev. Proc. 62-21. The system is based on broadly defined industry classifications, that is, industry activities. The class lives given are for a composite of assets used in the activity. With any composite system, the actual life of many of the assets in the class will be longer than that of the class and the actual life of many other assets in the class will be shorter than that of the class. The asset classification system evolved from a voluntary system in 1962 to the fixed system of MACRS in which the recovery periods can only be changed by Congress. Section 5.03 of Rev. Proc. 87-56, 1987-2 C. B. at 675, provides,

> "Certain asset guideline classes in Rev. Proc. 83-35 included property on the basis of regulated accounts. For purposes of § 168 of the Code and this revenue procedure, asset classes include property described therein without regard to whether a taxpayer is a regulated public utility or an unregulated company."

See 2 H. R. Conf. Rep. No.841, 99th Cong., 2nd Sess., 1986-3 (Vol. 4) C. B. 40. This language recognizes that utility property does not have to be regulated to fit within certain asset classes of MACRS although some did for ACRS. FCC accounts are included in the description of certain telephone related assets, ICC accounts are included in the description of certain railroad related assets, and CAB accounts are included in the description of certain airline related assets. FERC accounts, however, are not specifically mentioned in Electric Utility Service Accounts, Asset Class 49.11 – Asset Class 49.15.

Distribution is the final step in the sale of electricity. Until recently, users of electricity generally did not pay for distribution separately from the charge for the generation, although in setting rates public utility commissions considered both aspects. The street lights consume electricity. The amount of electricity used for a particular light over any period can be estimated with a high degree of accuracy based on the estimated hours of use. No separate metering is necessary and running separate lines is frequently unnecessary. In the simplest case, the lighting fixture is placed where needed on existing distribution poles. The utility has electricity where street lighting is needed; thus, the utility provides the electricity and the equipment for producing the light as a part of its business of distributing the electricity.

Three revenue rulings consistent with our analysis that street lighting is part of distribution are mentioned below. Rev. Rul. 78-67, 1978-1 C. B. 64, discusses expenditures for light watchmen (a lighting fixture containing a photoelectric cell installed on a pole usually on a customer's premises similar in appearance to a street light). Rev. Rul. 78-67 concludes that expenditures for the light watchmen are additions to a utility's distribution system and are subject to the repair allowance provision that applied to ADR property. Rev. Rul. 83-146, 1983-2 C. B. 17, discusses propane storage tanks and related customer installations leased by retailer of propane and finds the propane storage tanks and related customer installations are related to the taxpayer's business of furnishing gas to customers. Finally, in Rev. Rul. 77-476, 1977-2 C. B. 5, an oil pipeline used by a public utility to move oil to an inland generation plant from the utility's dock is determined to be part of the activity of generation of electricity rather than pipeline transportation. This ruling shows that the asset classification system looks at activities broadly and is not intended to divide a taxpayer's business in a myriad of activities.

One question raised is whether the property described in FERC account 373 is part of electric distribution (described in Asset Class 49.14–Electric Utility Transmission & Distribution) or is the property used in a separate activity not described in the asset classification system. FERC accounts are not controlling for purposes of asset classification for income tax depreciation in the electric utility industry. The number of income tax depreciation asset classes for the electric utility industry is significantly smaller than the number of FERC accounts. The lack of many accounts for income tax depreciation does not mean that the assets listed in these FERC accounts, but not specifically mentioned in the depreciation asset classes, are excluded from the income tax asset classes, but, rather, that no reason exists to create separate accounts for income tax purposes. The Electric Utility Services Asset Classes, Asset Class 48.11 through Asset Class 48.15, are broad and inclusive of many activities that are separately described in great detail in FERC accounts.

Clearly, under § 1.167(a)-11(b)(4)(iii)(b) property is classified according to its primary use even though the activity in which such property is primarily used is insubstantial in relation to all the activities of a taxpayer. However, for an activity to be classified as a separate activity, the activity must be substantial (although it may be

insubstantial in relation to all of other activities of the taxpayer), significant, and separate; not, as here, merely part of the activity in question. Providing street lighting is simply part of distribution of electricity to the ultimate consumer. This activity is included in Asset Class49.14. The deregulation of the electric utility industry, which allows the sale of the street lighting equipment to a municipality, does not change the classification of street lighting assets owned by Taxpayer. For purposes of determining Taxpayer's depreciation deduction, these assets continue to be used as part of its business of distributing electricity. Likewise, recognizing that these assets may be sold by Taxpayer, purchased by a municipality, and subject to new ratemaking that acknowledges that Taxpayer would no longer own the assets does not indicate that these assets were never part of distribution.

Conclusion

Taxpayer has changed to an impermissible method of accounting. This change is outside the scope of Appendix § 2.01 of Rev. Proc. 97-37 because Taxpayer did not change to a permissible method of accounting. Accordingly, consent to make this change is not granted. Taxpayer should file amended returns for the year of change and subsequent years to reflect the correct method of depreciating street lighting.

In accordance with the power of attorney, we are sending a copy of this letter ruling to Taxpayer's authorized representative. We also are sending a copy of the letter ruling to Natural Resources (LM:NR) Industry Director, LMSB.

Sincerely yours,

/s/ Kathleen Reed

Kathleen Reed
Senior Technician Reviewer Branch 6
Office of Associate Chief Counsel
(Passthroughs and Special Industries)