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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR INDUSTRY DIRECTOR, NATURAL RESOURCES & CONSTRUCTION
LM:NRC

FROM: Kathleen Reed
Senior Technician Reviewer, Branch 6, Office of Associate Chief Counsel (Passthroughs and Special Industries), CC:PSI:6

SUBJECT: Denial of consent for change in method of accounting

In accordance with section 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) of the Internal Revenue Code, this Chief Counsel Advice is not to be cited as precedent.

LEGEND:

Taxpayer =

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Taxpayer filed a Form 3115, Application for Change in Accounting Method, to request permission to change its method of computing depreciation under § 168(a) for street lighting equipment. Taxpayer previously treated equipment used wholly for street lighting as included in asset class 49.14, Electric Utility Transmission and Distribution Plant, of 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 asset class of Rev. Proc. 87-56. Thus, Taxpayer believes that street lighting is described in § 168(e)(3)(C)(ii), that is, property that does not have a class life and is not otherwise classified under § 168(e)(2) or (3).

As a result, Taxpayer requested permission to change its method of computing depreciation under § 168(a) for street lighting from 150-percent declining balance method of depreciation over a 20-year recovery period to 200-percent declining balance method of depreciation over a 7-year recovery period. This method change would have been effective with the taxable year beginning B ("year of change"), and would have resulted in a net negative § 481(a) adjustment (decrease in taxable income) of $C. Taxpayer proposed to take this net negative § 481(a) adjustment into account ratably over 4 taxable years in computing taxable income, beginning with the year of change.

The issue is whether Taxpayer's requested method of depreciating street lighting is a permissible method of accounting for depreciation of this property under § 168(a).

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)(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 MACRS 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 7-year property, the depreciation method and recovery period generally are the 200-percent declining balance method of depreciation and a 7-year recovery period pursuant to, respectively, § 168(b)(1) and (c). For 20-year property, the depreciation method and recovery period generally are the 150-percent declining balance method of depreciation and a 20-year recovery period, pursuant to, respectively, § 168(b)(2) and (c). The applicable convention for 7-year and 20-year property is the half-year convention or the mid-quarter convention, as determined under § 168(d).

Rev. Proc. 87-56 divides 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. An asset that falls within both an asset category (that is, asset classes 00.11 through 00.4) and an activity category (that is, asset classes 01.1 through 80.0) would be included in the asset category. See Norwest Corp. & Subs. v. Commissioner, 111 T.C. 105, 156-64 (1998).

The asset class lives described in Rev. Proc. 87-56 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 § 168 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 section 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 Rev. Proc. 87-56 for purposes of § 168 although it did for former § 168 ("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 classes 49.11 through 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 a 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 into a myriad of activities.

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 class 49.14. 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 of electricity.

Taxpayer was granted a conference of right to discuss this issue on D, and also submitted a post-conference submission on its proposed change. Taxpayer, as stated at the conference and in its post-conference submission, believes that the ultimate use of the street lights determines the classification of street lights for depreciation purposes and since the street lights are used by its customers and not by Taxpayer, there is no asset class for such property and, thus, should be assigned a 7-year recovery period. We cannot accept this view based on our analysis set forth above as asset class 49.14 of Rev. Proc. 87-56 properly embraces street lights being part of that class for the electric utility activity conducted by Taxpayer.

Accordingly, we have denied consent to Taxpayer's requested method change. Taxpayer should file amended returns for the year of change and subsequent years to reflect the correct method of depreciating street lighting assets, and to increase taxable income for the amount of any net negative § 481(a) adjustment taken by Taxpayer that is attributable to its request to change the depreciation for street lighting assets.

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

Kathleen Reed