

Section 167.—Depreciation

26 CFR 1.167(a)-11: Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.

How are assets owned by a utility and used in its general business operations classified for depreciation purposes? See Rev. Rul. 2003-81, page 126.

Section 168.—Accelerated Cost Recovery System

(Also §§ 167, 446, 481; 1.167(a)-11.)

Depreciation of assets. This ruling provides guidance as to the proper asset class under Rev. Proc. 87-56, 1987-2 C.B. 674, to depreciate assets owned by a utility that are used in the business operations of the utility. Rev. Proc. 2002-9 modified and amplified.

Rev. Rul. 2003-81

ISSUE

What is the proper asset guideline class under Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785, for the depreciation of assets owned by a utility that are used in the general business operations of the utility?

FACTS

U, a utility, owns a steam production plant and engages in the production of electricity for sale (production of electricity). *U* purchases a work bench for the maintenance garage and uses the work bench to help repair various plant machinery and equipment that are damaged during the production of electricity. *U* also purchases a bookcase and uses the bookcase to hold training manuals and operation protocols in the plant supervisor's office. Additionally, *U* constructs a new parking lot outside the plant facility (parking lot *A*) for use by *U*'s plant employees. Finally, *U* constructs a new parking lot adjacent to its corporate headquarters (parking lot *B*), located 100 miles from the plant, for use by *U*'s corporate headquarters employees.

For regulatory accounting purposes, *U* includes certain assets that are used in its general business operations in various

general plant accounts under the Uniform System of Accounts prescribed for public utilities by the Federal Energy Regulatory Commission (FERC). Specifically, *U* includes the work bench in FERC account 394 (Tools, shop, and garage equipment), the bookcase in FERC account 391 (Office furniture and equipment), and both parking lots in FERC account 390 (Structures and improvements).

LAW AND ANALYSIS

Section 167(a) of the Internal Revenue Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear of property used in a trade or business or held for the production of income. The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in § 168(a); and (2) 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 either § 168(a) or § 168(g), the applicable recovery period is determined by reference to class life or by statute. See, for example, § 168(e). Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former § 167(m) as if it were in effect and the taxpayer had made an election under that section. Prior to its revocation, § 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary that reasonably reflects 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). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is

classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.

Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowances under § 168. Rev. Proc. 87-56 establishes two categories of depreciable assets: (1) asset classes 00.11 through 00.4, which consist of specific assets used in all business activities (asset categories); and (2) asset classes 01.1 through 80.0, which consist of assets used in specific business activities (activity categories) based on broadly defined industry classifications. The same item of depreciable property may be described in both an asset category and an activity category, in which case the item is classified in the asset category unless specifically excluded from the asset category or specifically included in the activity category. See *Norwest Corporation & Subsidiaries v. Commissioner*, 111 T.C. 105 (1998) (item included in both an asset category and an activity category (furniture and fixtures) should be placed in the asset category). The asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 00.11, Office Furniture, Fixtures, and Equipment, includes furniture and fixtures that are not a structural component of a building. This asset class includes assets such as desks, files, safes, and communications equipment. Assets in this class have a recovery period of 7 years for purposes of § 168(a) and 10 years for purposes of § 168(g).

Asset class 00.3, Land Improvements, includes improvements directly to or added to land, whether the improvements are section 1245 property or section 1250 property, provided the improvements are depreciable. Examples of the assets might include sidewalks, roads, canals, waterways, drainage facilities, sewers (not including municipal sewers in Class 51), wharves and docks, bridges, fences, landscaping, shrubbery, or radio and television transmitting towers. Asset class 00.3 does not include land improvements that are explicitly included in any other class, and buildings and structural components as defined in § 1.48-1(e) of the regulations. Assets in this class have a recovery period of 15 years for purposes of § 168(a) and 20 years for purposes of § 168(g).

Asset class 49.13, Electric Utility Steam Production Plant, includes assets used in the steam power production of electricity for sale, combustion turbines operated in a combined cycle with a conventional steam unit and related land improvements. This asset class also includes package boilers, electric generators and related assets such as electricity and steam distribution systems as used by a waste reduction and resource recovery plant if the steam or electricity is normally for sale to others. Assets in this class have a recovery period of 20 years for purposes of § 168(a) and 28 years for purposes of § 168(g).

Rev. Proc. 87-56 is an extension and modification of Rev. Proc. 62-21, 1962-2 C.B. 418. Rev. Proc. 62-21 abandoned the asset by asset approach of depreciation. Instead, all assets used in a particular industry classification (business activity), regardless of their nature, were grouped into a single class. See also *The Adoption of the Asset Depreciation Range (ADR) System*, Announcement 71-76, 1971-2 C.B. 503, 507. Rev. Proc. 62-21 included, in addition to assets grouped by broad industrial classifications, certain broad general asset classifications.

Non-tax categorizations such as FERC account practices generally are not controlling for purposes of asset classification for federal income tax depreciation. The number of federal income tax depreciation activity categories for the utility services industry is significantly smaller than the number of FERC accounts. The limited number of utility services activity categories does not mean that the assets listed in FERC accounts, but not specifically mentioned in the utility services activity categories, are excluded from the utility services activity categories. Instead, the utility services activity categories for federal income tax depreciation purposes (subclasses of asset class 49) are broad and include many activities and assets that are separately described in greater detail in FERC accounts.

The work bench that *U* includes in FERC account 394 is used to help repair various plant machinery and equipment items that are damaged during the production of electricity. The work bench helps keep *U*'s business activity running smoothly and efficiently and is used in connection with *U*'s business activity of

producing electricity that is described in asset class 49.13. Because the work bench is used in connection with *U*'s business activity of producing electricity, and is not described in an asset category, the work bench is classified in asset class 49.13.

The bookcase that *U* includes in FERC account 391 is used to hold training manuals and operation protocols. The bookcase is used in connection with *U*'s business activity of producing electricity and therefore is included in asset class 49.13, an activity category. The bookcase is also included in asset class 00.11, an asset category. An asset that is included in both an asset category and an activity category is placed in the asset category unless it is specifically excluded from the asset category or specifically included in the activity category. See *Norwest*. Because the bookcase is included in both asset class 00.11 and asset class 49.13, and not specifically excluded from asset class 00.11 or specifically included in asset class 49.13, the bookcase is classified in asset class 00.11.

U includes both parking lots in FERC account 390. Both parking lot *A* and parking lot *B* are used in connection with *U*'s business activity of producing electricity that is described in asset class 49.13, an activity category, and both are also described in asset class 00.3, an asset category. An asset that is included in both an asset category and an activity category is placed in the asset category unless it is specifically excluded from the asset category or specifically included in the activity category. Asset class 00.3 specifically excludes land improvements that are explicitly included in any other class. Asset class 49.13 specifically includes land improvements that are related to assets used in the steam power production of electricity for sale. Thus, any land improvements used in connection with *U*'s business activity of producing electricity and related to assets used in the steam power production of electricity for sale are classified in *U*'s activity category, asset class 49.13. Parking lot *A*, located outside the plant facility, is considered a "related land improvement" under asset class 49.13 because parking lot *A* is related to the plant that produces the electricity. Conversely, parking lot *B*, located adjacent to *U*'s corporate headquarters 100 miles from the plant, is not considered a "related land improvement" under asset class 49.13 because parking lot *B*

is not related to the plant that produces the electricity. Accordingly, *U*'s parking lot *A* is classified in asset class 49.13; *U*'s parking lot *B* is classified in asset class 00.3.

HOLDINGS

Based on the facts described above, the workbench is classified in asset class 49.13; the bookcase is classified in asset class 00.11; parking lot *A* (located outside the plant facility) is classified in asset class 49.13; and parking lot *B* (adjacent to *U*'s corporate headquarters located 100 miles from the plant) is classified in asset class 00.3.

CHANGE IN METHOD OF ACCOUNTING

A change in a taxpayer's treatment of depreciable property to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446(e) and 481 and the regulations thereunder apply.

A taxpayer wanting to change the method of accounting for depreciable property that is owned by the taxpayer at the beginning of the year of change and for which the taxpayer has used an impermissible method of accounting for two or more consecutive taxable years immediately preceding the year of change, to conform with this revenue ruling must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9, 2002-3 C.B. 327 (as modified and amplified by Rev. Proc. 2002-19, 2002-13 C.B. 696, as amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432, and as modified and clarified by Announcement 2002-17, 2002-8 C.B. 561) or any successor, with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to change its method of accounting for the cost of depreciable property to conform with this revenue ruling for either its first or second taxable year ending after December 31, 2001, provided the taxpayer's method of accounting for the cost of depreciable property is not an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) for taxable years under examination, before an appeals office, or before a

federal court at the time the Form 3115 is filed with the national office; and

(2) To assist the Internal Revenue Service in processing changes in method of accounting under this revenue ruling, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002-9 is modified to require that a Form 3115 filed under this revenue procedure include the statement: "Automatic Change Filed Under Rev. Rul. 2003-81." This statement should be legibly printed or typed on the appropriate line on the Form 3115.

AUDIT PROTECTION

A utility taxpayer, which owns a steam production plant and engages in the production of electricity for sale, may continue to use its present method of treating the cost of depreciable property described in an asset category (asset classes 00.11 through 00.4) or a specific utility services activity class (asset classes 49.11 through 49.4) that was placed in service during any taxable year ending on or before June 27, 2003, if use of such method results in a longer recovery period than would be required by this revenue ruling.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this change in method of accounting under section 2 of the APPENDIX.

DRAFTING INFORMATION

The principal author of this revenue ruling is Alan Cooper of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact John Huffman at (202) 622-3110 (not a toll-free call).