IRS issues safe harbor 'repairs' guidance for electric generation

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In brief

The IRS recently issued Rev. Proc. 2013-24, which provides safe harbor definitions of units of property and major components that taxpayers may use in determining whether expenditures to maintain, replace, or improve steam or electric power generation property must be capitalized under Section 263(a). In addition, Rev. Proc. 2013-24 provides guidance on obtaining automatic consent to change to a method of accounting that uses all, or some, of the unit of property definitions.

In detail

Rev. Proc. 2013-24 applies to taxpayers that have a depreciable interest in power generation property primarily used in the trade or business of generating or selling steam or electricity. It provides guidance that taxpayers may use to determine whether the cost to replace a particular generation asset is a capital improvement or deductible expense. In making this determination, a key factor is whether the replacement is for an entire unit of property or a major component -- in which case it would be capitalized -- or whether the replacement is for a smaller component and thus deductible.

The new guidance provides safe harbor definitions of "unit of property" and "major component" that, if used by an eligible taxpayer, will not be challenged by the IRS. Rev. Proc. 2013-24 applies only to the property defined in Appendix A of the guidance.

In 2011, the IRS issued Rev. Proc. 2011-43, which provides a safe harbor method of accounting that taxpayers may use to determine whether expenditures to maintain, replace, or improve electric transmission and distribution (T&D) property must be capitalized under Section 263(a). Rev. Proc. 2013-24 and Rev. Proc. 2011-43 complete the guidance available to an electric utility company to assist in determining the appropriate units of property, which is the first step in determining whether expenditures to repair electric generation and T&D property should be expensed or capitalized.

Observations: The now-withdrawn proposed tangible property regulations issued in 2008 (2008 regulations) proposed four units of property for a fossil generation station. However, the 2008 regulations did not detail the applicable major components. Although taxpayers were not able to rely on the 2008 regulations, many taxpayers looked to them for insight as to the IRS's thinking in this area. The temporary regulations issued in 2011 also address units of property for "plant property," a term that includes generation assets, and define the units of property by first looking to a functional interdependence test, and then further dividing the unit of property into smaller units comprised of a component or components that perform a discrete and major function or operation within the functionally interdependent machinery and equipment. The major components set forth in

Rev. Proc. 2013-24 are significantly smaller than the units of property proposed in the 2008 regulations, so this new guidance may result in an unfavorable Section 481(a) adjustment for some taxpayers.

Unlike Rev. Proc. 2011-43, which provided units of property for the replacement of electric T&D linear and non-linear property as well as a safe-harbor 10% repair allowance computation, Rev. Proc. 2013-24 does not provide a comparable percentage replacement test to provide a safe harbor repair allowance. As a result, questions may arise as to whether, for example, the replacement of 90% of the blades in the low-pressure section of a turbine would be a deductible repair.

Accounting method change

A taxpayer that chooses to change to the accounting method provided by Rev. Proc. 2013-24 must use the automatic change procedures in Rev. Proc. 2011-14, as modified by Rev. Proc. 2013-24. Similar to Rev. Proc. 2011-43 for T&D property, the new procedure requires filing a copy of the Form 3115 with the IRS in Ogden, UT in lieu of filing a copy with the IRS National Office in Washington, DC. Rev. Proc. 2013-24 also waives the normal scope limitations (for example, for taxpayers under exam) but only for the taxpayer's first, second, or third tax year ending after December 30, 2012 -- i.e., 2012, 2013, or 2014 for calendar-year taxpayers.

A Section 481(a) adjustment must be used to implement the accounting method change. Similar to the electric T&D property guidance provided by Rev. Proc. 2011-43, the new procedure allows for a test period and extrapolation approach to determine the Section 481(a) adjustment.

Observation: Unlike the general rule for taking a Section 481(a) adjustment into account, whereby a taxpayer-favorable Section 481(a) adjustment is taken into account entirely in the year of change but a taxpayer-unfavorable adjustment is taken into income ratably over four years beginning with the tax year in which the accounting method change is effective -- Rev. Proc. 2013-24 requires both favorable and unfavorable adjustments to be taken into account entirely in the year of change.

Extrapolation approach

Appendix B of Rev. Proc. 2013-24 offers guidance to taxpayers that choose to apply the accounting method provided in the new guidance by using an extrapolation approach to determine the Section 481(a) adjustment, as follows:

- The taxpayer first applies the method prescribed to a testing period of recent, representative years, and derives an average repair deduction under the method of accounting, as a percentage of total capital additions.
- This percentage then is 'haircut' for each year removed from the test years and is adjusted based upon the number of test years; thus, the more test years, the smaller the haircut.
- This percentage next is applied to the adjusted capital additions for prior years in which extrapolation is used to derive a deemed Section 481(a) adjustment.
- Finally, the adjustments from the extrapolated years are combined with the repairs in the test years to arrive at the total Section 481(a) adjustment.

Observation: The extrapolation procedures under Rev. Proc. 2013-24 differ significantly from the extrapolation procedures provided in Rev. Proc. 2011-43 for electric T&D property. As a result of these changes, it is anticipated that a Section 481(a) adjustment resulting from Rev. Proc. 2013-24 will be less favorable than the adjustment provided under Rev. Proc. 2011-43.

Testing period

Taxpayers must use a testing period consisting of a minimum of three consecutive tax years (unless one of the tax years in that period is not representative).

Observation: Unlike Rev. Proc. 2011-43, which required use of the year of change as one of the three test years, Rev. Proc. 2013-24 allows taxpayers to choose whether to include the year of change in the test period. For example, a calendar-year taxpayer desiring to change its method of accounting under Rev. Proc. 2013-24 for its 2012 calendar year may use a test period consisting of either its 2010-2011-2012 calendar years or its 2009-2010-2011 calendar years.

Under Rev. Proc. 2013-24, the testing years must be representative of all years included in the Section 481(a) adjustment. A year is determined as representative by taking into account restructuring transactions, including acquisitions and dispositions, as well as any other events that may have triggered large capital additions. If a year is not representative, the data collected from that year must be excluded from the testing period and data from the fourth-most-recent tax year must be used to establish a testing period.

Observation: Rev. Proc. 2013-24 is not clear as to what constitutes a non-representative year and how to compute an amount for repairs for non-representative years. Presumably, the IRS is attempting to prevent an atypical repair percentage (resulting from the test period) from being applied against prior-year capital additions. Taxpayers should try to prevent the test years from being 'diluted' by any significant capital additions that are not deductible repairs.

The takeaway

Rev. Proc. 2013-24, which was issued pursuant to the IRS's Industry Issue Resolution (IIR) program, reflects a further effort on the part of the IRS and affected taxpayers in the electric utility industry to resolve subjective issues arising under Section 263(a).

As with other IIR safe harbor guidance, although Rev. Proc. 2013-24 provides safe harbors that affected taxpayers are not required to use, the IRS anticipates that taxpayers will follow Rev. Proc. 2013-24 to minimize controversy regarding the issues described in the new guidance.

Let's talk

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