

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting. (Also Part I, §§ 167, 168, 446, 481; 1.446-1, 1.481-1.)

Rev. Proc. 2007-48

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor method of accounting to treat rotatable spare parts as depreciable assets in accordance with Rev. Rul. 2003-37, 2003-1 C.B. 717, and provides procedures for taxpayers to obtain the automatic consent of the Commissioner of Internal Revenue to change to the safe harbor method of accounting.

SECTION 2. BACKGROUND

.01 In both *Hewlett-Packard Co. v. United States*, 71 F.3d 398 (Fed. Cir. 1995), *rev'g Apollo Computer, Inc. v. United States*, 32 Fed. Cl. 334 (1994), and *Honeywell, Inc. v. Commissioner*, T.C. Memo. 1992-453, *aff'd per curiam*, 27 F.3d 571 (8th Cir. 1994), the courts held that the taxpayers properly treated their pools of rotatable spare parts as depreciable assets, rather than as inventory. The taxpayers in *Hewlett-Packard* and *Honeywell* were engaged in the trade or business of manufacturing computers and computer parts, and also in the

business of repairing and servicing computers purchased or leased by their customers. Most of the taxpayers' computer maintenance operations were conducted pursuant to standardized maintenance agreements that obligated the taxpayers to provide all parts and labor, product upgrades, preventive maintenance, and telephone assistance necessary to keep a customer's computer operational for the duration of the contract (usually one year) in exchange for a predetermined fee. In conducting their computer maintenance operations, the taxpayers sent repair technicians to a customer's location to diagnose and repair the customer's computer. The taxpayers' repair technicians used a supply of rotatable spare parts to diagnose problems in a customer's equipment, and then would exchange a working part for any malfunctioning part. The malfunctioning part removed from the customer's equipment would then be repaired and placed in the taxpayers' rotatable spare parts pools for continued use in the maintenance operation. The taxpayers followed this practice of exchanging their rotatable spare parts for malfunctioning parts in a customer's computer to avoid rendering a customer's computer inoperative while the original part was being repaired.

The parts in the taxpayers' rotatable spare parts pools were obtained from the taxpayers' manufacturing facilities. However, the taxpayers operated their computer maintenance operations separate from their manufacturing operations and at all times the rotatable spare parts were physically segregated from the taxpayers' regular manufacturing inventories.

.02 In Rev. Rul. 2003-37, the Internal Revenue Service announced that it will follow the judgments in *Hewlett-Packard* and *Honeywell*, and that a taxpayer may treat rotatable spare parts as depreciable assets, provided the taxpayer's facts are substantially similar to the facts in those cases.

.03 The Service and Department of the Treasury are aware that the treatment of rotatable spare parts as depreciable assets has continued to be the subject of controversy in situations when a taxpayer, as part of its maintenance operations, sells rotatable spare parts from the taxpayer's pool of rotatable spare parts that are treated as depreciable assets. For reasons of administrative convenience, and to reduce further controversy, if a taxpayer within the scope of this revenue procedure maintains one or more pools of rotatable spare parts that it treats as depreciable assets and sells rotatable spare parts from these pools, the Service will not challenge the taxpayer's treatment of the pools of rotatable spare parts as depreciable assets for a particular taxable year if, for that year, the taxpayer uses the method of accounting provided in section 4 of this revenue procedure.

.04 Section 167(a) of the Internal Revenue Code provides a depreciation allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business. The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. Depreciation allowances under § 168 are determined using either: (1) the general depreciation system (GDS) in § 168(a); or (2) the alternative depreciation system (ADS) 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 GDS or ADS, the applicable recovery period is determined by reference to class life or by statute.

.05 Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785, sets forth the class lives of depreciable tangible property that are necessary to determine the recovery period of that property under § 168. The revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities.

.06 Pursuant to § 167(c), the basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property generally is the adjusted basis provided in § 1011 for the purpose of determining the gain on the sale or other disposition of such property. See also § 1.168(b)-1(a)(3) and (a)(4) of the Income Tax Regulations for the definitions of unadjusted depreciable basis and adjusted depreciable basis, respectively, for purposes of § 168.

.07 Under § 446(b), the Commissioner has broad authority to determine whether a method of accounting clearly reflects income. Section 1.446-1(c)(2)(ii) provides that the Commissioner may authorize a taxpayer to adopt or change to a permissible method of accounting although the method is not specifically permitted if, in the opinion of the Commissioner, that method clearly reflects income.

.08 Section 446(e) and § 1.446-1(e)(2)(i) state that, except as otherwise

provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions necessary to obtain the Commissioner's consent to effect the change in method of accounting and to prevent amounts from being duplicated or omitted. The terms and conditions the Commissioner may prescribe include the year of change, whether the change is to be made with a § 481(a) adjustment or on a cut-off basis, and the § 481(a) adjustment period.

.09 Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432), provides procedures by which a taxpayer may obtain automatic consent to change to a method of accounting described in the Appendix of Rev. Proc. 2002-9.

.10 Section 481(a) requires adjustments necessary to prevent amounts from being duplicated or omitted by reason of a change in method of accounting.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer that --

(1) repairs customer-owned (or customer-leased) equipment under warranty or maintenance agreements that are provided to the customer for either no charge or a predetermined fee that does not change during the term of the agreement (regardless of the taxpayer's costs to comply with the agreement);

(2) is obligated under the warranty or maintenance agreements to repair the customer's equipment (including all parts and labor related to the repair) for either no charge or a nominal service fee that is unrelated to the actual cost of parts and labor provided;

(3) maintains a pool or pools of spare parts that are used primarily in the taxpayer's maintenance operation of repairing customer-owned (or customer-leased) equipment under warranty or maintenance agreements, exchanges the spare parts for defective parts in the customer-owned (or customer-leased) equipment, and generally repairs and reuses the defective parts in its pool of spare parts (the "rotable spare parts"); and

(4) has a depreciable interest in the rotatable spare parts and has placed in service the rotatable spare parts after 1986.

SECTION 4. SAFE HARBOR METHOD OF ACCOUNTING FOR ROTABLE SPARE PARTS

.01 In General. This section 4 describes a safe harbor method of accounting for rotatable spare parts. A taxpayer is eligible to use the safe harbor method of accounting in any taxable year in which the taxpayer --

(a) is within the scope of section 3 of this revenue procedure; and

(b) has gross sales (less returns) of rotatable spare parts from the taxpayer's maintenance operation that do not exceed 10 percent of the taxpayer's total gross revenues (less returns) from its maintenance operation for the taxable year.

.02 Description of Safe Harbor Method of Accounting. A taxpayer using

the safe harbor method of accounting for rotatable spare parts must --

(1) capitalize the cost of the rotatable spare parts under § 263(a) and depreciate these parts under § 168 in accordance with section 4.03 of this revenue procedure;

(2) establish one or more pools for the rotatable spare parts in accordance with section 4.04 of this revenue procedure;

(3) identify the disposed rotatable spare parts in accordance with section 4.05 of this revenue procedure; and

(4) determine the depreciable basis of the rotatable spare parts for depreciation purposes in accordance with § 167(c), § 1011, and § 1.168(b)-1(a)(3) and (a)(4).

.03 Depreciation Allowable.

(1) *In general.* For purposes of determining the depreciation allowable for the rotatable spare parts under the safe harbor method of accounting described in section 4.02 of this revenue procedure, the applicable depreciation method for the rotatable spare parts is determined under § 168(b)(1) or (2), as applicable, unless either (a) the taxpayer made a timely valid election under § 168(b)(5) to use the straight line method of depreciation for the class of property (as set forth in § 168(e)) in which the rotatable spare parts are included, or (b) the rotatable spare parts are required to be depreciated under the alternative depreciation system in § 168(g). Rotatable spare parts required to be depreciated under the alternative depreciation system include rotatable spare parts in a class of property (as set forth in § 168(e)) for which the taxpayer made a timely valid

election under § 168(g)(7). In addition, the applicable recovery period for the rotatable spare parts is determined under § 168(c) or 168(g), as applicable, by including the rotatable spare parts in the following asset class of Rev. Proc. 87-56:

(a) the asset class in Rev. Proc. 87-56 applicable to the taxpayer's manufacturing activity if the taxpayer, under warranty or maintenance agreements, repairs only customer-owned (or customer-leased) equipment that is manufactured only by the taxpayer; or

(b) asset class 57.0, *Distributive Trades or Services*, if: (i) the taxpayer, under warranty or maintenance agreements, repairs both customer-owned (or customer-leased) equipment that is manufactured by the taxpayer and customer-owned (or customer-leased) equipment that is manufactured by others; (ii) the taxpayer is not a manufacturer of the type of customer-owned (or customer-leased) equipment that is being repaired; or (iii) the taxpayer (including a taxpayer described in section 4.03(1)(a) of this revenue procedure) charges the customer a nominal service fee (that is unrelated to the actual cost of parts and labor provided) to repair customer-owned (or customer-leased) equipment under warranty or maintenance agreements.

(2) *Additional first year depreciation deduction.* In determining the amount of the § 481(a) adjustment as described in section 5.04 of this revenue procedure, the additional first year depreciation deduction allowable under § 168(k), 1400L(b), or 1400N(d) is taken into account for any qualifying rotatable spare part. However, the deemed placed-in-service date referred to in section 5.04(2)(b) of this revenue procedure for the rotatable spare part is not the

acquisition date of the rotatable spare part for purposes of the acquisition date requirement in § 168(k), 1400L(b), or 1400N(d).

.04 Establishment of Pools.

(1) *In general.* Under the safe harbor method of accounting described in section 4.02 of this revenue procedure, a taxpayer must establish one or more pools for the rotatable spare parts. Each pool must include only the rotatable spare parts that are placed in service by the taxpayer in the same taxable year and have the same: (a) asset class under Rev. Proc. 87-56, (b) applicable depreciation method, (c) applicable recovery period, and (d) applicable convention. Additionally, rotatable spare parts subject to the mid-quarter convention may only be grouped into a pool with rotatable spare parts that are placed in service in the same quarter of the taxable year.

(2) *General asset account election.* If a taxpayer within the scope of this revenue procedure is changing the treatment of its rotatable spare parts to the safe harbor method of accounting described in section 4.02 of this revenue procedure, the taxpayer also may elect to establish general asset accounts for the rotatable spare parts beginning in the year of change, provided the terms and conditions in section 5.02(5) of this revenue procedure are satisfied beginning in the year of change.

.05 Dispositions.

(1) *In general.* Under the safe harbor method of accounting described in section 4.02 of this revenue procedure, a taxpayer must use a method of accounting provided in this section 4.05 for identifying the disposed

rotable spare parts. Any method other than one provided in this section 4.05 (including the ~~Net additions~~ method) is not a permissible method of accounting for dispositions.

(2) *Permissible methods of identifying disposed rotatable spare parts.*

For purposes of the safe harbor method of accounting described in section 4.02 of this revenue procedure, a taxpayer must use one of the following methods of accounting to identify its disposed rotatable spare parts:

(a) Specific identification of each disposed rotatable spare part; or

(b) A first-in, first-out method of accounting if, in the case of rotatable spare parts that are mass assets, the total rotatable spare parts dispositions during a particular taxable year are readily determined from a taxpayer's records but it is impracticable for the taxpayer to maintain records from which the taxpayer can determine the particular taxable year in which the disposed rotatable spare parts were placed in service by the taxpayer. A taxpayer using the first-in, first-out method of accounting under this section 4.05(2)(b) must identify the rotatable spare parts disposed of in a taxable year from the pool with the earliest placed-in-service year existing at the beginning of the taxable year of the disposition. For purposes of this paragraph, mass assets are a mass or group of individual items of depreciable property --

(i) that are not necessarily homogeneous;

(ii) each of which is minor in value relative to the total value of the mass or group;

- (iii) numerous in quantity;
- (iv) usually accounted for only on a total dollar or quantity basis;
- (v) with respect to which separate identification is impracticable; and,
- (vi) that are placed in service by the taxpayer in the same taxable year.

SECTION 5. CHANGES IN METHOD OF ACCOUNTING

.01 *In General.* Any change in a taxpayer's treatment of rotatable spare parts pursuant to this revenue procedure is a change in method of accounting to which § 446 and (except as otherwise provided in this section 5) § 481, and the regulations thereunder, apply. This section 5 applies to a taxpayer within the scope of this revenue procedure that --

(1) currently does not capitalize and depreciate the cost of its rotatable spare parts and wants to change to the safe harbor method of accounting described in section 4.02 of this revenue procedure;

(2) currently treats its rotatable spare parts in accordance with sections 4.02(1), (3), and (4) of this revenue procedure and wants to establish rotatable spare parts pools in accordance with section 4.04(1) of this revenue procedure;

(3) currently treats its rotatable spare parts in accordance with sections 4.02(1), (2), and (4) of this revenue procedure and wants to change to a method of accounting described in section 4.05(2) of this revenue procedure for

identifying the disposed rotatable spare parts; or

(4) currently treats its rotatable spare parts in accordance with sections 4.02(1) and (4) of this revenue procedure and wants to establish rotatable spare parts pools in accordance with section 4.04(1) of this revenue procedure and change to a method of accounting described in section 4.05(2) of this revenue procedure for identifying the disposed rotatable spare parts.

.02 *Automatic Change*. A taxpayer within the scope of this revenue procedure is granted the consent of the Commissioner to make a change in method of accounting described in section 5.01 of this revenue procedure provided that the taxpayer follows the automatic change in method of accounting provisions in Rev. Proc. 2002-9 (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 make the change in method of accounting for its first or second taxable year ending on or after December 31, 2006, provided the taxpayer's method of accounting for rotatable spare parts is not an issue under consideration for taxable years under examination, within the meaning of section 3.09 of Rev. Proc. 2002-9, at the time the Form 3115, *Application to Change a Method of Accounting*, is filed with the national office.

(2) For purposes of completing line 1a of Form 3115, the designated automatic accounting method change number for the changes in method of accounting provided in section 5.01 of this revenue procedure is No. 109.

(3) The taxpayer must compute any applicable § 481(a) adjustment in accordance with section 5.04 of this revenue procedure.

(4) The taxpayer must own the rotatable spare parts as of the beginning of the year of change and must determine the adjusted depreciable basis of the rotatable spare parts as of the beginning of the year of change in accordance with § 167(c), § 1011(a), and § 1.168(b)-1(a)(3) and (a)(4). The reductions required by § 1016(a)(2) for the depreciation allowable for the rotatable spare parts must be determined under the method of accounting for depreciation allowable under section 4.03 of this revenue procedure for all open and closed taxable years prior to the year of change.

(5) If a taxpayer described in section 4.04(2) of this revenue procedure elects to establish general asset accounts for the rotatable spare parts, the taxpayer must meet all of the following requirements beginning in the year of change:

(a) The taxpayer must consent to, and agree to apply, all of the provisions of § 1.168(i)-1 to the rotatable spare parts included in the general asset accounts, beginning with the year of change. Thus, pursuant to § 1.168(i)-1(k)(1), the establishment of general asset accounts beginning with the year of change is irrevocable and will be binding on the taxpayer for computing taxable income for the year of change and for all subsequent taxable years, except as provided in § 1.168(i)-1(c)(1)(ii)(A), (e)(3), (g), or (h)(1).

(b) The taxpayer must use a method of accounting described in section 4.05(2) of this revenue procedure for identifying the disposed rotatable

spare parts for purposes of applying § 1.168(i)-1(i).

(c) The taxpayer must group the rotatable spare parts into one or more general asset accounts in accordance with the rules in § 1.168(i)-1(c) and each general asset account must include a beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the general asset account. The beginning balance for the unadjusted depreciable basis of each general asset account is equal to the sum of the unadjusted depreciable bases as of the beginning of the year of change for all rotatable spare parts included in that general asset account. The beginning balance of the depreciation reserve of each general asset account is equal to the portion of the accumulated depreciation component of the net § 481(a) adjustment that is allocable to the rotatable spare parts included in that general asset account.

.03 Changes Made on a Cut-off Method. A taxpayer making a change in method of accounting described in section 5.01(2), (3), or (4) of this revenue procedure must make the change on a cut-off method. Thus, the new method of accounting applies to rotatable spare parts placed in service, or disposed of, by the taxpayer beginning in the year of change.

.04 Changes Made Using a § 481(a) Adjustment.

(1) *In general.* A taxpayer making a change in method of accounting under section 5.01(1) of this revenue procedure to the safe harbor method of accounting must make the change using a § 481(a) adjustment. As required by the Form 3115, the taxpayer must attach a summary of the computation and an explanation of the methodology used to determine the

§ 481(a) adjustment. To use the safe harbor method of accounting, the taxpayer also must include in the required attachment the amount of the taxpayer's total gross sales (less returns) of rotatable spare parts and gross revenues (less returns) from the taxpayer's maintenance operation for the year of change and every year of the qualifying period used to compute the § 481(a) adjustment.

(2) Computation of § 481(a) Adjustment.

(a) In computing the § 481(a) adjustment, the taxpayer must use the adjusted depreciable basis of the rotatable spare parts computed under the safe harbor method, as of the first day of the year of change taking into account the placed-in-service date provided for in subparagraph (2)(b) of this section 5.04 and the qualifying period described in subparagraph (3) of this section 5.04.

(b) Any rotatable spare parts that were: (i) placed in service by the taxpayer after 1986 and in a taxable year prior to the earliest taxable year of the qualifying period, and (ii) owned by the taxpayer as of the beginning of the earliest taxable year of the qualifying period, must be treated as placed in service by the taxpayer in the earliest taxable year of the qualifying period. A taxpayer that does not have the books and records to determine whether it meets the requirements of section 4.01 of this revenue procedure in every year in which the rotatable spare parts on hand as of the beginning of the year of change were placed in service and in every subsequent year prior to the year of change, must compute the § 481(a) adjustment using a qualifying period that can be established based on its books and records.

(3) *Qualifying period.* For purposes of this section 5.04, a “qualifying period” consists of the taxable year, or consecutive taxable years, immediately preceding the year of change during which the taxpayer can establish that it meets the requirements of section 4.01 of this revenue procedure.

.05 *Nonautomatic Changes.* If a taxpayer is not eligible to change to the safe harbor method of accounting provided in this revenue procedure, the taxpayer may request to change its method of accounting for treating rotatable spare parts by filing a Form 3115 with the Commissioner in accordance with the requirements of § 1.446-1(e)(3)(i) and Rev. Proc. 97-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432).

.06 *Requirement to Change From the Safe Harbor Method.* A taxpayer that changes to the safe harbor method under this revenue procedure and subsequently fails to meet the requirements of section 4.01 of this revenue procedure must change its method of accounting for rotatable spare parts to an appropriate inventory method of accounting for the first taxable year in which the taxpayer becomes ineligible to use the safe harbor method of accounting for rotatable spare parts. A taxpayer that is required to change its method of accounting under this section 5.06 must file a Form 3115 in accordance with the automatic change in method of accounting provisions of Rev. Proc. 2002-9 (or any successor), with the following modifications:

(1) the scope limitations in section 4.02 of Rev. Proc. 2002-9 do not

apply; and

(2) the designated automatic accounting method change number for changes in method of accounting from the safe harbor method of accounting made pursuant to this section 5.06 is No. 110.

SECTION 6. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 2002-9 is modified and amplified to include the accounting method changes described in this revenue procedure in section 3 of the APPENDIX.

.02 Section 2.01(1)(d)(xiii)(A) of the APPENDIX of Rev. Proc. 2002-9 (as modified by Rev. Proc. 2004-11, 2004-1 C.B. 311) is modified to read as follows:

(A) a change in inventory costs (for example, when property is reclassified from inventory property to depreciable property, or vice versa) (but see section 3.02 of this APPENDIX for making a change in method of accounting from inventory property to depreciable property for unrecoverable line pack gas or unrecoverable cushion gas, and Rev. Proc. 2007-48, 2007-29 I.R.B. **[enter page number of IRB]** for making a change in method of accounting from inventory property to depreciable property for rotatable spare parts);

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2006. The Service will not challenge a taxpayer's use of the safe harbor method of accounting described in section 4.02 of this revenue procedure in an earlier taxable year if the taxpayer, for that taxable year, meets the requirements of section 4.01 of this revenue procedure. Moreover, if a taxpayer

currently uses the safe harbor method of accounting described in section 4.02 of this revenue procedure and the use of such method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) in examination, before an appeals office, or before the U.S. Tax Court and the taxpayer meets the requirements of section 4.01 of this revenue procedure for the taxable years under examination, before an appeals office, or before the U.S. Tax Court, the issue will not be further pursued.

SECTION 8. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-2070. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in section 5.04(1). This information is required to determine whether the taxpayer qualifies to use the safe harbor method of accounting. The collection of information is required to obtain a benefit. The likely respondents are business or other for-profit institutions. The estimated total annual reporting and/or recordkeeping burden is 75 hours. The estimated annual frequency of responses is 300.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax information are confidential, as

required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is Gwen Turner of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Turner at (202) 622-5020 (not a toll free call). For further information regarding the method of computing depreciation for rotatable spare parts, the establishment of pools or general asset accounts for rotatable spare parts, or the method of identifying the disposed rotatable spare parts, contact Douglas Kim of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622-4930 (not a toll-free call).