Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:[redacted]:TL-N-595-01
[redacted]

date: MAR 8 2001

to: LMSB Division, Heavy Manufacturing, [redacted]
[redacted], MCT [redacted]

from: LMSB Practice Group, Area [redacted], [redacted]

---

subject: [redacted]
Form 3115 for Initial Grading and Clearing Costs

This memorandum responds to your request for advice regarding the need for technical advice to address problems with [redacted]'s application of the change of accounting method approved by the National Office on May 23, 1997.

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether, under the circumstances described, you must refer your determinations with respect the Taxpayer's application of an approved change in accounting method to the National Office for consideration before making any adjustments.

CONCLUSION

No.

FACTS

[redacted] (the "Taxpayer") is a public utility company that files a federal income tax return on a calendar year basis using an accrual method of accounting.

On [redacted], the Taxpayer filed Form 3115, Application for Change in Accounting Method, seeking permission to change its method of accounting with respect to the depreciation of capitalized initial clearing and grading costs of public utility right-of-way easements (the "Clearing Costs") placed in service from [redacted] through [redacted]. The Taxpayer sought the change for the taxable year ending [redacted].

On Form 3115, the Taxpayer represented that the property with respect to which the Taxpayer requests the change in accounting method is used in the distribution and/or transmission of electricity. The Taxpayer further represented that it treated the Clearing Costs as part of either nonresidential real property, depreciating the costs over 31.5 or 39 years, or Asset Class 49.14, depreciating the costs over 20 years. The Taxpayer concluded that, pursuant to Revenue Ruling 72-403, it had improperly treated the Clearing Costs and must depreciate the Clearing Costs using the "default" recovery periods of five years or seven years provided under I.R.C. § 168 for ACRS and MACRS, respectively. As a result of the change in method, the Taxpayer represented that the net negative adjustment required by I.R.C. § 481(a) was $[redacted].

The National Office approved the Taxpayer's request on May 23, 1997 and issued a letter ruling containing the following language:

> . . . The Taxpayer represents that it has used the present method of accounting since [redacted] and such accounting method constitutes a "Category A" method of accounting. . . . The Taxpayer further represents that the costs included in calculating the section 481(a)

> adjustment are costs of initial clearing and grading of public utility transmission rights-of-way easements as specified in Rev. Rul. 72-403, 1972-2 C.B. 102.
>
> . . .
>
> The issue is the proper method of accounting for depreciation of capitalized initial clearing and grading costs of public utility rights-of-way easements placed in service during the Taxpayer's [redacted] through [redacted] taxable years.
>
> Rev. Rul. 72-403 holds that the costs of initial clearing and grading of rights-of-way easements are subject to depreciation.
>
> . . .
>
> Initial clearing and grading costs of public utility rights-of-way easements are excluded from both asset class 00.3 (Land Improvements) and asset class 49.14 (Electric Utility Transmission and Distribution Plant) of Rev. Proc. 87-56. The Taxpayer represents that the costs are section 1245 real property with no class life. . . .
>
> . . .
>
> . . . On its timely filed Form 3115, the Taxpayer represents that the entire net negative adjustment required under section 481(a) for the year of change is -$[redacted]. The amount of this adjustment is subject to verification by the district director upon examination of the Taxpayer's return.
>
> . . .
>
> Based on the Taxpayer's representations and the analysis as set forth above, the Taxpayer is granted permission to change its method of accounting from the present method to the proposed method . . .

The letter ruling acknowledged that the Compliance Division would verify the amount of the net adjustment under I.R.C. § 481(a) and would otherwise determine whether the Taxpayer fully complied with its terms and conditions.

You have identified two problems with respect to the Taxpayer's application of the change in accounting method.[1]

First, while the Taxpayer represented that it treated the Clearing Costs as part of nonresidential real property and asset class 49.14, you were unable to verify that the Taxpayer actually classified the Clearing Costs as such. If the Taxpayer classified these costs as other asset classes, the cumulative depreciation for the years from [redacted] through [redacted] may be larger. Consequently, the Taxpayer may have overstated the adjustment under I.R.C. § 481(a).

Second, you have determined that some costs claimed by the Taxpayer as Clearing Costs are not initial clearing and grading costs for right-of-way easements as contemplated by Revenue Ruling 72-403 and, therefore, are not costs having a 7-year recovery period under MACRS. For example, the Taxpayer has treated a portion of the costs associated with a work order for replacing and upgrading a substation as Clearing Costs. It is unclear whether the Taxpayer has any basis for treating these costs as Clearing Costs. Similarly, the Taxpayer has treated certain costs associated with roads, surfaces, and trails as Clearing Costs. The Taxpayer argues that if such roads, surfaces, and trails are constructed solely for the purpose of providing access to the [redacted] and [redacted], the costs of construction should be included in the Clearing Costs. At this stage, the Taxpayer has not provided any documentation showing that the costs claimed in this category meet this criteria.

DISCUSSION

The Compliance Division of the Internal Revenue Service must apply a letter ruling in determining a taxpayer's liability unless it finds that the letter ruling should be revoked or modified. Rev. Proc. 97-1, § 12.02, 1997-1 C.B. 433, 465; Rev. Proc. 97-27, § 11.01, 1997-1 C.B. 680, 690. The Compliance Division will ascertain if:

1. the representations on which the ruling was based reflect an accurate statement of the material facts;

---

[1] It is our understanding that you have doubts regarding whether the method previously used by the Taxpayer is a "Category A" method but do not propose to recommend modification of the letter ruling on this ground.

2. the amount of the adjustment under I.R.C. § 481(a) was properly determined;
3. the change in method of accounting was implemented as proposed in accordance with the terms and conditions of the consent agreement;
4. there has been any change in the material facts on which the ruling was based during the period the method of accounting was used; and
5. there has been any change in the applicable law during the period the method of accounting was used.

Rev. Proc. 97-27, § 11.01. If the Compliance Division recommends that the ruling (other than the amount of the adjustment under I.R.C. § 481(a)) be revoked or modified, it will forward the matter to the National Office for consideration before it takes any further action. Rev. Proc. 97-27, § 11.02. This referral is treated as a request for technical advice. Id.

In this case, the Taxpayer sought approval for a change in its method of accounting for depreciation of the Clearing Costs. In its application, the Taxpayer made several representations regarding its then current method of accounting for these costs.

The National Office consented in the letter ruling to the change in method, because the Clearing Costs have no class life, as held in Revenue Ruling 72-403 and, therefore, are 7-year property under I.R.C. § 168(e)(3)(C)(ii). In reaching this conclusion, the National Office did not need to rely on any representations made by the Taxpayer in its Form 3115.

You do not challenge the conclusions reached in the letter ruling, because clearly to the extent the Taxpayer has initial clearing and grading costs relating to the acquisition of right-of-way easements, it is entitled to depreciate the costs in accordance with Revenue Ruling 72-403. Therefore, you would not recommend the modification or revocation of the letter ruling and would not need to refer the matter to the National Office for consideration. Rev. Proc. 97-27, § 11.02.

You do, however, take exception to the computation of the adjustment under I.R.C. § 481(a). In its Form 3115, the Taxpayer makes representations regarding the classification of these costs under its then current method of accounting. As noted, these representations are not material to the ultimate conclusion reached in the letter ruling, i.e., the proper method of accounting for the Clearing Costs; rather they are material to the computation of the adjustment under I.R.C. § 481(a).

As stated in the letter ruling, you are expected to verify and correct the amount of the adjustment proposed by the Taxpayer. And you may do so without seeking approval from the National Office. Rev. Proc. 97-27, § 11.02 ("If the district director recommends that the ruling (other than the amount of the § 481(a) adjustment) should be modified or revoked, the district director will forward the matter to the national office for consideration.")(emphasis added).

You also take exception to the costs treated as Clearing Costs by the Taxpayer. Because Revenue Ruling 72-403 does not explicitly identify all of the costs, you may wish to request technical advice on what constitutes a Clearing Cost. We do not believe, however, that you have sufficient information to request technical advice at this point.

If you have any questions, please call me at [redacted].

[redacted]
Associate Area Counsel (LMSB)

By: [redacted]
Attorney