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Cable System Operators: New Safe Harbors for Applying the Tangible Property Regulations

The IRS issued industry-specific guidance that includes safe harbors that cable system owners may use in lieu of the fact-intensive tangible property regulations. This article reviews the guidance, providing insights into the relative advantages of the new safe harbors compared with the tangible property regulations; the article advises each taxpayer to carefully weigh its own situation against the options available in the new guidance.

The Internal Revenue Service has issued industry-specific guidance regarding the application of the Tangible Property Regulations ("TPR")¹ to cable system operators. Revenue Procedure 2015-12,² issued as part of the IRS's Industry Issue Resolution ("IIR") program, reflects the difficulties that owners of "network assets" such as cable systems would otherwise encounter in applying the fact-intensive criteria of the TPR. The new guidance is not mandatory, but instead provides two alternative safe harbors—a "network asset maintenance allowance" and a "unit of property" method—that taxpayers within the scope of the guidance may use in determining whether costs incurred in connection with cable network assets may be deducted as routine repairs and maintenance, or instead must be capitalized under section 263(a) and recovered through depreciation.

The new revenue procedure provides separate criteria for applying the TPR to costs incurred in connection with installing or replacing customer drops and customer premises equipment.³

¹ T.D. 9636, 78 Fed. Reg. 57686 (Sept. 19, 2013).

² 2015-2 I.R.B. 265.

³ Revenue Procedure 2015-12 also updates and supersedes Revenue Procedure 2003-63, 2003-2 C.B. 304, addressing application of the depreciation provisions of sections 167 and 168 to cable network assets. A separate discussion of this aspect of Rev. Proc. 2015-12 will appear in a future issue of *What's News in Tax*.

Each of these alternatives is a method of accounting whose use requires the consent of the IRS. As have other IIRs issued in connection with the implementation of the TPR, Revenue Procedure 2015-12 grants “automatic consent” for taxpayers to make the changes in their methods of accounting necessary to implement these new methods, and waives the normally applicable “scope limitations” for the taxpayer’s first two tax years beginning after December 31, 2013.

Scope

Revenue Procedure 2015-12 makes the new safe harbors available to any cable system operator, including a subsidiary or other downstream affiliate, that has a depreciable interest in “cable network assets” used in a cable system, as defined in the revenue procedure. Taxpayers “primarily” engaged in providing wireline or wireless telecommunication services are excluded from the scope of this IIR, and instead are instructed to apply TPR-related IIRs previously issued for wireline⁴ and wireless⁵ telecommunications providers. Even for traditional telecommunications providers, though, the new safe harbors should be applicable to any cable network assets that are held within an entity (such as a separate subsidiary) that is not primarily engaged in providing telecommunications services.

Eligible taxpayers may apply either of the two optional methods to their “cable network assets,” which Revenue Procedure 2015-12 defines as personal or real property used in a cable system to provide video, high-speed internet, and voice-over-internet-protocol (“VOIP”) phone services (collectively, “cable services”) to customer premises in the United States. These assets consist of operating plant and equipment that receives signals and transmits programming from the headend⁶ to the customer, including signal receiving equipment, encoding and decoding devices, cables, connectors, switches, amplifiers, and distribution equipment at or near customer locations.

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

⁴ Rev. Proc. 2011-27, 2011-1 C.B. 740.

⁵ Rev. Proc. 2011-28, 2011-1 C.B. 743.

⁶ The headend is the primary location in a cable system that provides television programming signals (through satellite antennae or fiber optic cables) for distribution to customer premises through a cable distribution network. The headend processes and combines signals for distribution to hubs. Section 4.05 of Rev. Proc. 2015-12.

For purposes of the new safe harbors, cable network assets specifically exclude all intangible property (with the exception of certain types of software used in the operation of the cable distribution facilities), as well as certain categories of tangible property. Excluded tangible property includes land and land improvements, non-cable network buildings and improvements (such as call centers, service centers, and headquarters buildings), furniture and fixtures, general purpose office equipment, vehicles, and customer premises equipment (e.g., set-top boxes, modems, routers, and remotes used by the customer).

Revenue Procedure 2015-12 provides detailed definitions of each of these and other types of cable network assets.⁷

Network Asset Maintenance Allowance

In lieu of applying the detailed and highly factual standards of the TPR, eligible cable system operators may use the optional “network asset maintenance allowance” (“NAMA”) method for cable network assets. This method closely parallels earlier maintenance allowance safe harbors provided for wireline and wireless telecommunications providers. As such, eligible companies engaged in providing both telecommunications and cable services will find the new rules familiar and hopefully straightforward to implement.

If elected, the NAMA essentially allows the cable operator to deduct for tax purposes an amount equal to 12 percent of its network-related book additions for the year, with certain modifications. More specifically, after identifying the book additions for cable network assets placed in service during the year, the taxpayer must subtract the costs of customer drops capitalized during the year (those costs are subject to a separate safe harbor discussed below); costs capitalized for book purposes but that are deducted or deferred for federal tax purposes (e.g., research and experimental expenses); and costs for cable assets acquired during the year through certain types of transactions.

After identifying the eligible pool of capital additions, the taxpayer determines the tax basis of those assets (generally the tax basis

⁷ Section 4 of Rev. Proc. 2015-12.

determined under section 1016), and multiplies that amount by 12 percent. The result is the taxpayer's total network maintenance allowance amount for that tax year, which may be deducted under section 162.⁸ The revenue procedure clarifies that this amount may be deducted in addition to operation and maintenance costs that generally are deductible for both financial statement and federal tax purposes.

In other words, the cable provider generally will continue to deduct for tax purposes network-related expenditures that are expensed for book purposes, and also will now deduct an additional amount equal to 12 percent of the company's book additions for network assets placed in service that year. The remainder of the capitalized book additions must be capitalized for tax purposes under section 263(a).

The NAMA is a method of accounting rather than an annual election and as such, once adopted, the taxpayer must continue to use the NAMA unless the IRS consents to discontinue its use. Further, the NAMA must be applied on an all-or-nothing basis, with no "cherry picking" allowed. Instead, the NAMA becomes the exclusive means for the taxpayer to determine the extent to which cable network asset costs that are capitalized for financial statement purposes are deductible or instead must be capitalized for federal tax purposes (except for customer drops and costs deductible under section 174).

For example, a cable system operator choosing the NAMA may not apply the TPR's routine maintenance safe harbor⁹ to deduct amounts capitalized for financial accounting purposes but that would have been deductible under the TPR. The taxpayer's ability to apply the TPR's *de minimis* rule should not be affected however, because by definition that annual election only applies to amounts that are expensed for financial accounting purposes.¹⁰

The principal benefit of using the NAMA lies in not being required to apply the highly factual standards of the TPR to the taxpayer's network-related

⁸ Although not stated in Rev. Proc. 2015-12, the taxpayer also should consider the potential application of section 263A to these costs.

⁹ Section 1.263(a)-3(i).

¹⁰ Section 1.263(a)-1(f).

expenditures. In particular, the taxpayer is not required to determine whether and how to apply the TPR's unit of property ("UOP") definitions to its cable system network. As the IRS has acknowledged, applying the UOP definitions to such network assets has vexed both taxpayers and the IRS for many years. The NAMA eliminates the need to do so.

The NAMA also provides more flexibility than does the book-conformity safe harbor provided by the TPR. That safe harbor allows taxpayers to make an annual election to capitalize under section 263(a) any repair and maintenance costs that also are capitalized that year for financial accounting purposes.¹¹ Once elected, however, the book-conformity safe harbor is irrevocable for that year. For some taxpayers, this election provides an attractive source of simplification and certainty. At the same time however, this election tends to "overcapitalize" repair and maintenance costs, which, because the election is irrevocable, cannot be recovered later through an accounting method change and accompanying section 481(a) adjustment. This, and the fact that the election does not resolve the treatment of repair and maintenance costs that are expensed for book purposes, represent unavoidable drawbacks to the book-conformity safe harbor.

For eligible cable system operators, the NAMA provides an attractive alternative. Like the TPR's book conformity election, the NAMA relieves the taxpayer of the need to identify its units of property, apply the TPR's highly factual capitalization criteria, and potentially be required to defend its determinations before the IRS. Unlike the book-conformity safe harbor, however, the NAMA is an accounting method. While the method change procedures required to begin using the NAMA are slightly more cumbersome than the election statement required by the book-conformity election, it – like all accounting methods – is reversible. This preserves the option of later changing to the unit of property method (or to the full TPR), and in doing so, compute a section 481(a) adjustment that recovers any costs that were "overcapitalized" in a prior year under the NAMA, but that have not yet been recovered through depreciation.

¹¹ Section 1.263(a)-3(n).

Unit of Property Method

As did the earlier IIRs issued to telecommunications providers, Revenue Procedure 2015-12 provides an alternative “unit of property” method for applying the TPR to cable network assets. Under this alternative, the taxpayer may choose to apply the general standards of the TPR (other than the UOP definitions) to specific UOPs listed in the revenue procedure. This menu of UOPs for cable network assets allows the taxpayer to avoid the difficult task of identifying how to segment its cable system network into specific UOPs, and then defend those choices in the event of an IRS exam challenge.

Instead, the IRS will accept as UOPs for purposes of the TPR.¹²

- All programming reception equipment, including antenna and satellite dishes
- All towers, antenna support structures, and satellite dish support structures affixed to foundations
- All concrete foundations upon which a tower, antenna support structure, or satellite support structure is installed, as well as associated anchoring equipment
- Each headend building and each hub¹³ building (including its structural components)
- The headend equipment
- All depreciable land improvements, including landscaping, fences, and sidewalks, but excluding buildings, enclosures, and improvements capitalized to land
- All equipment at the nodes
- The fiber optic distribution system, including fiber optic cable, related PVC conduit and protective sheathing, and associated

¹² Section 6.01(1) - (9) of Rev. Proc. 2015-12.

¹³ A hub is the secondary location in a cable system that is connected to the headend by fiber optic cable. A hub can serve a large number of business and residential communities. Section 4.06 of Rev. Proc. 2015-12.

devices (including taps¹⁴ and drops¹⁵), whether overhead or underground, excluding permanent conduits and ducts

- The coaxial distribution system, including coaxial cable, related PVC conduit or protective sheathing, and associated devices (including taps and drops), whether overhead or underground, but excluding permanent conduits and ducts

Importantly, this UOP determination is made for each individual “cable system,” rather than for the taxpayer’s entire cable network. For this purpose, a “cable system” means a facility consisting of a set of closed transmission paths and associated signal generation, reception, and control equipment that provides cable services to multiple subscribers within a “community.” A “community” in turn is defined as one or more geographically contiguous or proximate customer populations receiving cable services under one or more nonexclusive franchises granted by one or more state or local franchising authorities. The revenue procedure notes that, in general, a cable system is the lowest reporting unit of a cable system operator at which it maintains management reporting records.¹⁶

These definitions are critical in applying the UOP definitions under the unit of property method. For example, since an acceptable UOP means the collection of all programming reception equipment, it is important to include within that grouping only the reception equipment providing cable service to a particular community. Likewise, all of the fiber distribution system within (and only within) that community is a separate UOP, as is all of the coaxial cable distribution system. In contrast, because each headend building and each hub building is a separate UOP, a building’s association with a particular community is less important.

¹⁴ A tap is the equipment that is the final interconnection point within a cable distribution network and directs the signal to be delivered to a customer. A tap may be on a pole or in a pedestal on the ground. From the tap, the external drop runs to the customer premises. Section 4.11 of Rev. Proc. 2015-12.

¹⁵ Note that CPE is not included within the definition of “cable network assets” under section 4.02(g) of Rev. Proc. 2015-12. The unit of property method only applies to groupings of cable network assets, and so by its terms is inapplicable to CPE. As such, the inclusion of CPE as a component of this UOP is curious. Nonetheless, because taxpayers benefit from using the largest possible UOP in applying the TPR, this inclusion of a property not otherwise treated as cable network assets favors the cable operator.

¹⁶ Sections 4.02 and 4.03 of Rev. Proc. 2015-12.

Unlike the all-or-nothing application of the NAMA, the cable operator may cherry pick among these units of property, and may use one or more of these enumerated UOPs. Once selected however, that UOP determination applies to all assets in that grouping, including cable system property that the taxpayer subsequently acquires. Because it is treated as an accounting method, that selection can be changed only with IRS consent through the accounting method change process. As such, the cable operator should exercise care in choosing which of the UOPs listed in Revenue Procedure 2015-12 will be adopted pursuant to a change to the unit of property method of accounting. Additions to or deletions from the taxpayer's initial list of UOPs will require a subsequent accounting method change.¹⁷

The unit of property method provides an intermediate approach between the NAMA and full application of the TPR. Essentially, this method allows the taxpayer to avoid the most potentially problematic aspect of the TPR—identifying and defending its UOP determinations—while retaining the ability to carefully analyze the extent to which network-related expenditures that are capitalized for book purposes may nonetheless be deducted under the criteria of the TPR (for example, through application of the routine maintenance safe harbor). In that sense, the choice between the NAMA and the unit of property method will be determined by whether the cable operator places a higher priority upon administrative ease and certainty or instead upon the opportunity to potentially deduct larger percentages of each year's network related expenditures.

Customer Drops and CPE

Revenue Procedure 2015-12 provides separate methodologies for customer drops, meaning the property that connects the tap to the customer premises, and for customer premises equipment ("CPE"), described above. For purposes of the revenue procedure, a drop includes

¹⁷ Section 3.21(1)(b) of the Appendix to Revenue Procedure 2011-14, as amended by Revenue Procedure 2015-12. The revenue procedure does not require the taxpayer to attach an actual list of the chosen UOPs to the Form 3115 filed to effectuate a change to the unit of property method.

both aerial and underground customer drops, as well as external¹⁸ and internal drops.¹⁹

Revenue Procedure 2015-12 provides the taxpayer with two options regarding customer drops– the specific identification method and a safe-harbor allocation method.

Under the specific identification method, customers specifically identify the costs incurred for customer drops (including installation costs) and treat them as follows:

- **External Drops:** The direct and indirect costs of installing an *initial* external drop must be capitalized (unless deductible under another code section, such as section 174), but the taxpayer may deduct the direct and indirect costs of *replacing* an external drop that does not better or adapt it to a new or different use under the standards of the TPR. This should allow cable operators to deduct the costs of replacing drops with the same materials (a “like-for-like” replacement), but leaves open the question of the circumstances under which replacing a drop with one composed of a different type of material either better or adapts that drop to a new or different use.
- **Internal Drops.** The direct and indirect costs of installing or replacing any internal drop may be deducted.

Alternatively, the cable operator may instead use a new safe-harbor allocation method for customer drops. Under this method, the taxpayer treats 12 percent of the total customer-drop costs for the year as being for the installation of initial external drops (and so capitalized under section 263(a)), and the remainder as being costs for the installation of internal drops and for external drop replacements. This larger portion generally is deductible, except to the extent the costs relate to either the betterment or adaptation of an external drop to a new or different use.

In other words, of the total costs incurred for customer drops during the tax year, 12 percent must be capitalized, and the remaining 88 percent generally may be deducted, although some diligence must be performed

¹⁸ An external drop is the cable and associated connectors that run from the tap to the exterior of the customer’s premises. Section 4.14 of Rev. Proc. 2015-12.

¹⁹ An interior drop includes the cable and associated connectors within the customer’s premises. Section 4.15 of Rev. Proc. 2015-12.

to determine the extent to which (if any) the costs relate to betterments or adaptations of an external drop to a new or different use.

In contrast with drops, the costs of acquiring CPE are subject to the general standards of the TPR, with installation costs being deductible under section 162. As with other acquisition costs, this will allow cable system operators to deduct the costs of purchasing CPE if (as is often the case) each item falls within the scope of a qualifying *de minimis* election under section 1.263(a)-1(f).

Planning Considerations

Having been developed under the auspices of the IRS's Industry Issue Resolution program, Revenue Procedure 2015-12 reflects some level of input and participation by the cable industry. As such, the quantitative measures set forth in the various safe harbors presumably are keyed to the industry's actual experiences to date. As with any global standard, the benefits of the NAMA's fixed, quantitative safe harbors will vary from operator to operator, as will the relative priorities each cable system operator places upon administrative convenience versus maximizing potential deductions for repair and maintenance costs. In that sense, the various options provided by Revenue Ruling 2015-12 in accounting for cable network assets under the TPR provide an attractive level of flexibility for the industry. Each cable system operator will need to carefully weigh its own situation against each of these options to choose the optimal path for cable network assets.

Importantly, cable system operators should not overlook the need to assess how the TPR apply to their non-network assets, such as call centers, service centers, vehicles, headquarters and other administrative buildings, and similar types of tangible property. For many cable system operators, non-network assets represent a material portion of the company's tangible property. The TPR—including the regulations' UOP definitions—will continue to apply to those assets.²⁰

²⁰ For a broader discussion of the TPR, please see James Atkinson, "An Analysis of the Final Repair Regulations," 141 Tax Notes 535 (Oct. 10, 2013).



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