Section 263.—Capital Expenditures

26 CFR 1.263(a)–1: Capital expenditures.
(Also §§ 471; 1.471–1 and §§ 167; 167(a)–1.)

Capital expenditures; rotable spare parts. This ruling informs taxpayers that the Service will follow *Hewlett Packard, Inc., v. United States*, 71 F.3d 398 (Fed. Cir. 1995), *rev'g Apollo Computer, Inc. and Subsidiaries v. United States*, 32 Fed. Cl. 334 (1994, and *Honeywell, Inc. and Subsidiaries v. Commissioner*, T.C. Memo 1992–453, *aff'd*, 27 F.3d 571 (8th Cir. 1994). Accordingly, taxpayers may treat rotable spare parts as depreciable assets if the taxpayer's facts are substantially similar to *Hewlett Packard* and *Honeywell*.

Rev. Rul. 2003–37

The Internal Revenue Service will follow *Hewlett Packard, Inc. v. United States*, 71 F.3d 398 (Fed. Cir. 1995), *rev'g Apollo Computer, Inc. and Subsidiaries v. United States*, 32 Fed. Cl. 334 (1994), and *Honeywell, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 1992–453, *aff'd*, 27 F.3d 571 (8th Cir. 1994). Accordingly, taxpayers may treat rotable spare parts as depreciable assets if the taxpayer's facts are substantially similar to *Hewlett Packard* and *Honeywell*.

In *Hewlett Packard*, the taxpayer manufactured and sold computers and related products, and provided maintenance and repair services under its product warranties and maintenance agreements. Most of the taxpayer's computer maintenance business was conducted pursuant to standardized maintenance agreements that obligated the taxpayer 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 its computer maintenance business, the taxpayer operated a separate repair facility and sent technicians to its customers' locations. The taxpayer maintained a pool of "rotable spare parts" obtained from its manufacturing facility. The taxpayer's repair technicians would use this supply of rotable spare parts to diagnose problems in the customer's equipment. A customer's part that had been identified as the probable cause of the malfunction was replaced with the identical functioning part from the taxpayer's rotable spare parts pool. The malfunctioning part removed from the customer's equipment would then be repaired and returned to the taxpayer's rotable spare parts pool for continued use in the maintenance business. The taxpayer followed this practice of exchanging its rotable spare parts for parts in a customer's computer to avoid rendering the computer inoperative while the original part was repaired.

On its federal income tax returns for the years at issue, the taxpayer treated its pool of rotable spare parts as a capitalized fixed asset, which it depreciated and on which it took investment tax credits. The Service disallowed the depreciation deductions and investment tax credits on the ground that the taxpayer was required to characterize its pool of rotable spare parts as property held primarily for sale in the ordinary course of business that should be included in inventory.

The Court of Federal Claims entered judgment in favor of the Service. The court concluded that a sale had occurred whenever the taxpayer exchanged one of its rotable spare parts with a customer's part. However, the Court of Appeals for the Federal Circuit reversed, holding that the taxpayer's pool of rotable spare parts was a capital asset used to provide services to customers under its computer maintenance contracts. The Appeals Court disagreed with both the characterization of the exchange of rotable spare parts as a sale and the characterization of the parts as inventory.

Similarly, in *Honeywell*, the Tax Court held that a pool of rotable spare parts was not held for sale and that the taxpayer was not required to treat the individual parts as inventory. The court stated that the pool of rotable spare parts was necessary to the operation of the taxpayer's maintenance service business and was similar to an asset used in its trade or business within the meaning of § 167 of the Internal Revenue Code to earn revenue from its maintenance agreements. The Court of Appeals for the Eighth Circuit affirmed the Tax Court's decision.

The Service has concluded, based on the above cases, that a taxpayer may treat rotable spare parts as depreciable assets if the taxpayer's facts are substantially similar to those of the above cases. The Service intends to issue a revenue procedure under which qualifying taxpayers may apply to obtain automatic consent to change to a method of accounting consistent with *Hewlett Packard* and *Honeywell*. The Service intends to issue the revenue procedure in time for taxpayers to make the change for taxable years ending on or after December 31, 2002.

With respect to taxpayers who sell parts from their rotable spare parts pools, the Service requests comments on the maximum amount of rotable spare parts sales that should be permitted from a rotable spare parts pool that is treated as a depreciable asset under the rationale of *Hewlett Packard* and *Honeywell* and how such amount should be measured (*e.g.*, sales price of parts sold as a percentage of total revenues for the taxpayer's computer maintenance business). The Service also requests comments on any other issues that should be addressed in the revenue procedure. Comments should be submitted by May 23, 2003, either to:

Internal Revenue Service
P.O. Box 7604
Washington, DC 20044
Attn: CC:PA:RU (ITA:1)
Room 5553

or electronically at: *Notice.Comments@irscounsel.treas.gov* (the Service's comments e-mail address). All comments are available for public inspection and copying.

Drafting Information

The principal author of this revenue ruling is Gwen Turner of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Turner at (202) 622–5020 (not a toll-free call).