

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to:
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from: Ellen M. Carey
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(Large Business & International)

subject: Disallowance of Section
168(k) Additional First-Year Allowance for Depreciation for "Excepted Trade or
Business" (2021)

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ISSUE

- (1) Whether Taxpayer may claim an additional first-year allowance for depreciation ("bonus depreciation") under Section 168(k) of the Internal Revenue Code ("Code") on property placed into service related to the construction of a solar generation plant for tax year ended December 31, 2021.

CONCLUSION

- (1) Taxpayer may not claim bonus depreciation under Section 168(k) of the Code on property placed into service related to the construction of a solar generation plant because Taxpayer is primarily engaged in an excepted regulated utility trade or business.

FACTS

files a consolidated federal income tax return on a calendar year basis using the accrual method of accounting with its affiliates (collectively "Taxpayer"). Taxpayer owns and operates electric transmission, distribution, and generation facilities and natural gas distribution facilities. Taxpayer is primarily engaged in the trade or business of furnishing and selling electrical energy.

LAW AND ANALYSIS

A. Bonus Depreciation

Section 168(k)(9)(A) provides “any property which is primarily used in a trade or business described in clause (iv) of Section 163(j)(7)(A)” does not constitute qualified property for the bonus depreciation deduction. Section 163(j)(7)(A)(iv) provides the term “trade or business” does not include excepted regulated utility trades or businesses, which is

the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

Treas. Reg. § 1.168(k)-2(b)(2)(ii)(F) further provides that property “will not meet the requirements [for additional first year depreciation deduction] if the property is primarily used in a trade or business described in Section 163(j)(7)(A)(iv) and Treas. Reg. §§ 1.163(j)-1(b)(15)(i), 1.163(j)-10(c)(3)(iii)(C)(3), and placed in service by the taxpayer in any taxable year beginning after December 31, 2017.”¹

To correspond with Treas. Reg. § 1.168(k)-2(b)(2)(ii)(F), Treas. Reg. § 1.163(j)-1(b)(15)(ii)(A) provides that taxpayers engaged in an excepted regulated utility trade or business cannot claim the additional first-year depreciation under Section 168(k) for any property that is primarily used in the excepted regulated utility trade or business.

B. Business Interest Expense Limitation

Section 163(j) provides a limitation on the amount of business interest expense that may be deducted in the current tax year. Section 163(j)(7)(A) provides the limitation does not apply to an excepted regulated utility trade or business.

a. Excepted Regulated Utility Trade or Business

Treas. Reg. § 1.163(j)-1(b)(15)(i) defines an excepted regulated utility trade or business as an automatically excepted regulated utility trade or business, an electing

¹ For purposes of Section 168(k)(9)(A) and Treas. Reg. § 1.168(k)-2(b)(2)(ii)(F), the term “primarily used” has the same meaning as used in Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b) for classifying property. Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b) provides “property shall be classified according to primary use even though the activity in which such property is primarily used is insubstantial in relation to all the taxpayer’s activities.”

regulated utility trade or business, or a designated excepted regulated utility trade or business. Under Treas. Reg. § 1.163(j)-1(b)(15)(i)(A), an automatically excepted regulated utility trade or business is

a trade or business that furnishes or sells electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, but only to the extent that the rates for the furnishing or sale of the items have been established or approved by a state or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any state or political subdivision thereof and such rates are determined on a cost of service and rate of return basis, or have been established or approved by the governing or ratemaking body of an electric cooperative.

Treas. Reg. § 1.163(j)-1(b)(15)(ii)(B) provides if the taxpayer is engaged in one or more excepted trades or businesses, and one or more non-excepted trades or businesses, the taxpayer must allocate items between the excepted and non-excepted trades or businesses. Further, some trades or businesses with de minimis furnishing or sales of items described in Treas. Reg. § 1.163(j)-1(b)(15)(i)(A)(1), that are not sold pursuant to rates that are determined on a cost of service and rate of return basis or established or approved by the governing or ratemaking body of an electric cooperative, may be treated as excepted trades or businesses.

b. Allocation of Interest Expense, Interest Income, and Other Tax Items to an Excepted Trade or Business

Treas. Reg. § 1.163(j)-10 provides the exclusive rules for allocating interest expense, interest income, and other tax items that are properly allocable to a trade or business between excepted and non-excepted trades or businesses.

Treas. Reg. § 1.163(j)-10(a)(4)(i) provides all members of a consolidated group are treated as a single corporation for purposes of applying the allocation rules. For example, the group rather than a particular member is treated as engaged in excepted or non-excepted trades or businesses.

Under Treas. Reg. § 1.163(j)-10(c), the general method of allocation is based on the approach that money is fungible and the interest expense is attributable to all activities and property, regardless of any specific purpose of incurring an obligation on which interest is paid.

Treas. Reg. § 1.163(j)-10(c)(1)(i) provides the taxpayer must determine the adjusted basis in its assets as of the close of the determination date in the current tax year and

average those amounts to determine the relative amounts of asset basis for its excepted and non-excepted trades or businesses for that year.

However, Treas. Reg. § 1.163(j)-10(c) contains several “de minimis” rules that must be applied *in the following order* when determining the extent to which asset basis is allocable to excepted and non-excepted trades or businesses.

First, Treas. Reg. § 1.163(j)-10(c)(3)(iii)(C)(3) provides if a taxpayer is engaged in a regulated utility trade or business, and if at least 90% of the output is furnished or sold by excepted regulated utility trades and businesses, then the taxpayer's entire trade or business is an excepted regulated utility trade or business.

Second, with respect to an asset used in more than one trade or business, Treas. Reg. § 1.163(j)-10(c)(3)(iii)(B) provides if at least 90% of the taxpayer's basis in the asset would be allocated to either excepted or non-excepted trades or businesses during a determination period, the taxpayer's entire basis in the asset for the determination period must be allocated to either excepted or non-excepted trades or businesses, respectively.

If the taxpayer's entire utility trade or business is treated as an excepted regulated utility trade or business under Treas. Reg. § 1.163(j)-10(c)(3)(iii)(C)(3), then Treas. Reg. § 1.163(j)-10(c)(3)(iii)(B) will not apply (unless an asset used by that business also is used in a non-excepted trade or business that is not a utility trade or business). Such is the case because, under Treas. Reg. § 1.163(j)-10(c)(3)(iii)(C)(3), none of the taxpayer's property used in the utility trade or business is treated as used in a non-excepted trade or business.

Third, under Treas. Reg. § 1.163(j)-10(c)(1)(ii), if at least 90% of the taxpayer's basis in all of its assets is allocable to either excepted or non-excepted trades or business, then all of the taxpayer's interest expense and interest income for that year that is properly allocable to a trade or business is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

If the 90% threshold in Treas. Reg. § 1.163(j)-10(c)(3)(iii)(C)(3) is satisfied, and if the de minimis rule in Treas. Reg. § 1.163(j)-10(c)(3)(iii)(B) does not apply (because none of the taxpayer's property is used in a non-excepted, non-utility trade or business), then 100% of the basis in assets used in the taxpayer's utility trades or businesses will be allocable to an excepted trade or business for purposes of the analysis in Treas. Reg. § 1.163(j)-10(c)(1)(ii).

c. Application of Basis Allocation Rules to This Case

[REDACTED]

However, Taxpayer's analysis does not comply with the allocation rules under Treas. Reg. § 1.163(j)-10.

[REDACTED]

[REDACTED]

[REDACTED]

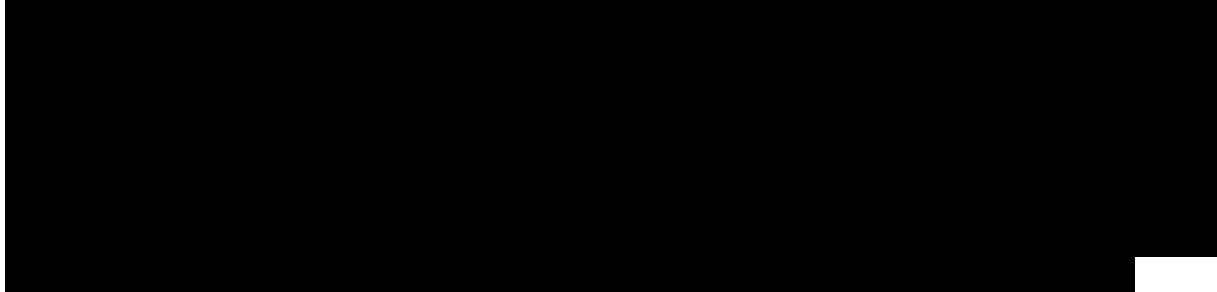
However, Taxpayer's analysis fails to apply the de minimis rules in the order required by Treas. Reg § 1.163(j)-10(c). As noted previously, Treas. Reg. § 1.163(j)-10(c)(3)(iii)(C)(3) must be applied *before* Treas. Reg. § 1.163(j)-10(c)(3)(iii)(B). Under Treas. Reg. § 1.163(j)-10(c)(3)(iii)(C)(3), Taxpayer is not treated as engaged in *any* non-excepted utility trades or businesses.

[REDACTED]

After applying Treas. Reg. § 1.163(j)-10(c)(3)(iii)(C)(3) and Treas. Reg. § 1.163(j)-10(c)(3)(iii)(B) *in that order*, Taxpayer then must apply Treas. Reg. § 1.163(j)-10(c)(1)(ii). If Taxpayer does not have any assets used in a trade or business other than a utility trade or business, then no further determination is necessary for purposes of Treas. Reg. § 1.163(j)-10(c)(1)(ii), and all of Taxpayer's assets are allocable to an excepted trade or business. If Taxpayer has assets used in a non-utility trade or business, then Taxpayer must apply Treas. Reg. § 1.163(j)-10(c)(1)(ii), taking into account determinations under Treas. Reg. § 1.163(j)-10(c)(3)(iii)(C)(3)—

that is, treating 100% of the asset basis of property used exclusively in a utility trade or business as allocable to an excepted trade or business.

CONCLUSION



If you have any questions, please do not hesitate to contact attorney Ellen Carey [redacted]
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