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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL, NATURAL RESOURCES (LMSB)

FROM: Mark Pitzer, Assistant to the Branch Chief, Branch 6, Office of Passthroughs and Special Industries, CC:PSI:6

SUBJECT: Classification for depreciation purposes of certain vessels used in the offshore energy industry

This Chief Counsel Advice responds to your memorandum dated November 16, 2001. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

ISSUE

How are Taxpayer's offshore supply vessels and marine support vessels that are bareboat-chartered to subsidiaries and then time-chartered to unrelated companies in the offshore energy industry and other business activities classified for depreciation purposes under section 168 of the Internal Revenue Code?

CONCLUSION

Taxpayer's vessels are classified for depreciation purposes in accordance with the business activities of the particular time charterers to whom they are chartered. Vessels that are chartered during the tax year to multiple time charterers engaged in different business activities are classified in accordance with the business activity in which they were primarily used during the tax year.

FACTS

Taxpayer owns offshore supply vessels and marine support vessels that are used to support all phases of offshore exploration, development and production, including: (1) towing of and anchor handling of mobile drilling rigs and equipment;

POSTF-154902-01

(2) transporting supplies and personnel necessary to sustain drilling; (3) work over and production activities; and (4) supporting pipe-laying and other offshore construction activities.

Taxpayer is structured as a series of boat-owning companies and operating companies. The boat-owning companies enter into bareboat charters with operating companies that they control, pursuant to which Taxpayer's subsidiaries/lessees are in complete possession, control, and command of the ship, and perform functions normally performed by the boat-owning companies. The operating companies then enter into time-charter arrangements with unrelated companies to transport people, supplies and equipment to drilling rigs, and to support the construction, positioning and ongoing operation of oil and gas production platforms. Some of Taxpayer's vessels are time-chartered to companies not engaged in offshore energy activities. The length of a particular time charter can vary from several days to several years, depending upon the particular contract, vessel, and requested vessel modifications.

Taxpayer classifies its vessels in asset class 13.0, Offshore Drilling, of Rev. Proc. 87-56, 1987-2 C.B. 674, for depreciation purposes. Domestic vessels are depreciated over 5 years and international vessels over 7.5 years. For book purposes, Taxpayer generally depreciates its vessels over a 25-year period.

Taxpayer contends that its main business is providing marine support vessels for the offshore energy industry. Moreover, Taxpayer represents that most of its revenue generated annually comes from major oil company clients. Taxpayer also asserts that its vessels are an integral part of offshore drilling.

LAW AND ANALYSIS

Section 167(a) of the Internal Revenue Code provides a depreciation allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income.

The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in section 168(a); and (2) the alternative depreciation system in section 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 section 168(a) or 168(g), the applicable recovery period is determined by reference to class life or by statute. Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former section 167(m) as if it

POSTF-154902-01

were in effect and the taxpayer were an elector. Prior to its revocation, section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations sets out the method for asset classification under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities. This section refers to the classification rule for leased property found in section 1.167(a)-11(e)(3)(iii), discussed further below.

Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowances under section 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. The same item of depreciable property can be described in both an asset category (that is, asset classes 00.11 through 00.4) and an activity category (that is, asset classes 01.1 through 80.0), in which case the item is classified in the asset category unless specifically described in the activity category. See Norwest Corporation & Subsidiaries v. Commissioner, 111 T.C. 105 (1998) (item described in both an asset and an activity category (furniture and fixtures) should be placed in the asset category). The asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 00.28, Vessels, Barges, Tugs and Similar Water Transportation Equipment, except those used in marine construction, is not further described by the revenue procedure. Assets in this class have a recovery period of 10 years for purposes of section 168(a) and 18 years for purposes of section 168(g).

Asset class 13.0, Offshore Drilling, includes assets used in offshore drilling for oil and gas such as floating, self-propelled and other drilling vessels, barges, platforms, and drilling equipment and support vessels such as tenders, barges, towboats and crewboats. Oil and gas production assets are excluded from asset class 13.0. Assets in this class have a recovery period of 5 years for purposes of section 168(a) and 7.5 years for purposes of section 168(g).

Asset class 13.1, Drilling of Oil and Gas Wells, includes assets used in the drilling of onshore oil and gas wells and the provision of geophysical and other exploration services; and the provision of such oil and gas field services as chemical treatment, plugging and abandoning of wells and cementing or perforating well casings. This asset class does not include assets used in the performance of any of these

POSTF-154902-01

activities and services by integrated petroleum and natural gas producers for their own account. Assets in this class have a recovery period of 5 years for purposes of section 168(a) and 6 years for purposes of section 168(g).

Asset class 13.2, Exploration for and Production of Petroleum and Natural Gas Deposits, includes assets used by petroleum and natural gas producers for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities. This class also includes petroleum and natural gas offshore transportation facilities used by producers and others consisting of platforms (other than drilling platforms classified in Class 13.0), compression or pumping equipment, and gathering and transmission lines to the first onshore transshipment facility. The assets used in the first onshore transshipment facility are also included and consist of separation equipment (used for separation of natural gas, liquids, and solids), compression or pumping equipment (other than equipment classified in Class 49.23), and liquid holding or storage facilities (other than those classified in Class 49.25). Support vessels are not included in this class. Assets in this class have a recovery period of 7 years for purposes of section 168(a) and 14 years for purposes of section 168(g).

Section 1.167(a)-11(e)(3)(iii) of the Income Tax Regulations provides that in the case of a lessor of property, unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for such property shall be determined as if the property were owned by the lessee.

Section 1.167(a)-11(e)(3)(iii) was considered by the court in Hauptli v. Commissioner, 902 F.2d 1505 (10th Cir. 1990). In Hauptli, the taxpayer purchased and leased gas cylinders to a lessee who, in turn, leased the cylinders to its customers. In ascertaining the appropriate class life for depreciation purposes of the taxpayer's cylinders, the court concluded that, as a practical matter, it should look to the activities of the end-user lessees of the cylinders because they were the ultimate users of the cylinders.

In accordance with section 168 and Rev. Proc. 87-56, if depreciable tangible assets are not included in any of the specific asset categories (asset classes 00.11 through 00.4) of Rev. Proc. 87-56, they are included in the specific business activity asset class (asset classes 01.1 through 80.0) that describes the business activity of the taxpayer with the depreciable interest in the property. In the present case, Taxpayer is not engaged in offshore drilling or any other offshore energy activity. Further, Taxpayer's business activity of chartering, or leasing, supply and support vessels is not described in asset class 13.0 or any other asset class of Rev. Proc. 87-56. Under these circumstances, section 1.167(a)-11(e)(3)(iii) and Hauptli indicate that the asset classification for Taxpayer's vessels is determined by looking to the business activities of the end-user lessees, the ultimate users of the vessels. Accordingly, we must look to the business activities of the time charterers of Taxpayer's vessels. In addition, if a vessel is chartered during the tax year to

POSTF-154902-01

multiple time charterers engaged in different business activities, a determination must be made as to the primary use of the vessel during the year. See section 1.167(a)-11(b)(4)(iii)(b).

In light of the preceding discussion, if the time charterers of Taxpayer's vessels are engaged in the business activity described in asset class 13.0, then Taxpayer's vessels are properly classified in asset class 13.0 for depreciation purposes. Accordingly, we must consider the scope of asset class 13.0. The specific business activity described by this asset class is offshore drilling. The facts indicate that some of Taxpayer's vessels have been time-chartered to companies not engaged in offshore energy activities. Clearly, if these vessels were primarily used by these companies for a tax year, they do not fall within the scope of asset class 13.0 for that year. In addition, while Taxpayer contends that its vessels are includible in asset class 13.0 because Taxpayer provides support vessels to the offshore energy industry, not all offshore energy activities are within the scope of asset class 13.0. Oil and gas production assets are specifically excluded from the class. Accordingly, if any of Taxpayer's vessels were primarily used during a tax year by time charterers engaged in production activities, these vessels would also be outside the scope of asset class 13.0.

We must now consider the question of whether the offshore drilling assets of producers are within the scope of asset class 13.0. This question arises because, while asset class 13.0 could be read broadly to include all offshore drilling (that is, contract drilling and drilling by producers), asset class 13.2 appears to include all drilling assets of producers with no exception for offshore drilling. To answer this question we will examine the historical evolution of the pertinent asset classes.

Rev. Proc. 62-21, 1962-2 C.B. 418, set forth guideline lives and rules for depreciation. The revenue procedure, which aggregated assets by industry for depreciation purposes, stated that the guideline lives set forth therein applied to broad classes of assets rather than to individual assets. Assets used in the oil and gas industry were addressed in class 17 of Group Three. A distinction was drawn between, and different lives were provided for, the drilling equipment of contract drillers and the drilling equipment of producers that performed drilling services for their own account.

The proper classification under Rev. Proc. 62-21 of certain assets used in offshore oil and gas exploration was addressed by the Service in Rev. Proc. 66-18, 1966-1 C.B. 646, which provided that:

[f]loating or self-propelled drilling vessels and barges, platforms, and support vessels, such as those used in the exploration for oil or gas in offshore operations, are classified in Group 2, Class 2(b), Marine Contract Construction with a guideline class life of 12 years.

POSTF-154902-01

Included is the vessel itself and all drilling equipment related thereto. Tenders, barges, towboats, crew boats and other vessels used to transport supplies, equipment, and personnel in offshore operations are classified in the same class. For activities of this kind, this classification includes equipment used in both force account and contract construction.

Rev. Proc. 72-10, 1972-1 C.B. 721, was published to implement the Class Life Asset Depreciation Range System (ADR) authorized by former section 167(m). Among the numerous asset guideline classes set forth by the revenue procedure were the following:

Asset class 00.28, Vessels, barges, tugs and similar water transportation equipment, except those used in marine contract construction.

Asset class 13.1, Drilling of oil and gas wells, includes assets used in the drilling of onshore oil and gas wells on a contract, fee, or other basis and the provision of geophysical and other exploration services; and the treatment, plugging and abandoning of wells and cementing or perforating well casings; but not including assets used the performance of any of these activities and services by integrated petroleum and natural gas producers for their own account.

Asset class 13.2, Exploration for petroleum and natural gas deposits, includes assets used for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities, when these are related activities undertaken by petroleum and natural gas producers.

Asset class 15.2, Marine contract construction, includes floating, self-propelled and other drilling platforms used in offshore drilling for oil and gas.

Rev. Proc. 77-10, 1977-1 C.B. 548, superceded Rev. Proc. 72-10 and modified the description of assets included in asset class 15.2 to be consistent with Rev. Proc. 66-18. The other asset classes described above remained essentially the same. Revised asset class 15.2 was described as follows:

Asset class 15.2, Marine Contract Construction, includes assets used by general contracting, special trade, and

POSTF-154902-01

heavy construction contractors predominantly in marine construction work. Does not include assets used by companies in performing marine construction services for their own account except for floating, self-propelled, and other drilling platforms and support vessels used in offshore drilling for oil and gas which are included whether used for their own account or others.

Rev. Proc. 78-5, 1978-1 C.B. 557, revised asset class 13.2 of Rev. Proc. 77-10 to include petroleum and natural gas offshore transportation facilities used by petroleum and natural gas producers and others in the offshore pipeline transportation of oil and natural gas. The revenue procedure states that these assets were formerly included in asset class 46.0, Pipeline Transportation. Revised asset class 13.2 reads as follows:

Asset class 13.2, Exploration for and Production of Petroleum and Natural Gas Deposits, includes assets used by petroleum and natural gas producers for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities. Also includes petroleum and natural gas offshore transportation facilities used by producers and others consisting of platforms (other than drilling platforms classified in Class 15.2), compression and pumping equipment, and gathering and transmission lines to the first onshore transshipment facility. The assets used in the first onshore transshipment facility are also included and consist of separation equipment (used for separation of natural gas, liquids, and solids), compression or pumping equipment (other than equipment classified in

Class 49.23), and liquid holding or storage facilities (other than those classified in Class 49.25). Does not include support vessels.

The “others” referred to in the description of asset class 13.2 include pipeline companies. In addition, the parenthetical language in the description makes it clear that drilling contractors’ drilling platforms continued to be included in asset class 15.2.

Rev. Proc. 77-10 was also modified by Rev. Proc. 80-58, 1980-2 C.B. 854, the stated purpose of which was to delete existing asset classes 15.1, Contract Construction Other than Marine, and 15.2, Marine Contract Construction, and to establish two new classes for assets used in construction (asset class 15.0) and in

POSTF-154902-01

offshore oil and gas drilling (asset class 13.0). Rev. Proc. 80-58 noted that asset class 15.2 included assets used in offshore oil and gas drilling. Thus, the assets used in offshore oil and gas drilling that had been included in former asset class 15.2 were moved to new asset class 13.0. The new asset classes established by Rev. Proc. 80-58 are set forth below:

Asset class 13.0, Offshore Drilling, includes assets used in offshore drilling for oil and gas such as floating, self-propelled and other drilling vessels, barges, platforms, and drilling equipment and support vessels such as tenders, barges, towboats and crew boats. Excludes oil and gas production assets.

Asset class 15.0, Construction, includes assets used in construction by general building, special trade, heavy and marine construction contractors, operative and investment builders, real estate subdividers and developers, and others except railroads.

Rev. Proc. 77-10 was superceded by Rev. Proc. 83-35, 1983-1 C.B. 745. Asset classes 13.0 and 15.0 in Rev. Proc. 83-35 were the same as set forth in Rev. Proc. 80-58. Asset class 13.2 was the same as set forth is Rev. Proc. 78-5, as modified by Rev. Proc. 80-58. Rev. Proc. 87-56 contains the same descriptions of asset classes 13.0, 13.2, and 15.0 that are contained in Rev. Proc. 83-35.

Our review of the evolution of these asset classes indicates that, since the inception of the asset classes, different classes have been provided for the drilling equipment of contract drillers and producers. The distinction established by Rev. Proc. 62-21 was maintained in subsequent revenue procedures. This is understandable because of the significant difference between the use of producer-owned offshore equipment, often dual purpose in nature (drilling and production), fixed in place over the life of the producing property, and the use of contractor-owned drilling equipment, which is mobile and continually in use as it searches for oil and gas in harsh environments. Taking cognizance of this difference, the drilling assets of contract drillers are presently included in asset classes 13.0 and 13.1, while the drilling assets of producers are included in asset class 13.2.

With regard to support vessels used in offshore drilling, these assets were classified by Rev. Proc. 66-18 and subsequent pronouncements as marine contract construction assets. These vessels were moved to asset class 13.0 from asset class 15.2 by Rev. Proc. 80-58. The support vessels of producers cannot be described as contract assets. Accordingly, we conclude that the offshore drilling assets of producers, including support vessels, are not within the scope of asset class 13.0. Therefore, in the present case, if any of Taxpayer's vessels were

POSTF-154902-01

primarily used during a tax year by producer time charterers engaged in offshore drilling, these vessels would be outside the scope of asset class 13.0.

In summary, we conclude that Taxpayer's support vessels time-chartered to contract drillers for use in, or in support of, contract drilling are includible in asset class 13.0. Taxpayer's support vessels time chartered to companies that are not contract drillers are not includible in asset class 13.0. Taxpayer's support vessels that, during the same tax year, are time chartered to both contract drillers and companies that are not contract drillers are includible in asset class 13.0 if the vessels were primarily used by contract drillers during the year. This determination is made on a vessel-by-vessel basis. Taxpayer's support vessels not classified in asset class 13.0 or classified as marine contract construction assets in asset class 15.0 are includible in asset class 00.28. We note that asset class 13.2 specifically excludes support vessels.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[REDACTED] the decision in Duke Energy Natural Gas Corporation v. Commissioner, 173 F.3d 1255 (10th Cir. 1999). Duke owned and operated various systems of interconnected subterranean natural gas gathering pipelines and related compression facilities (gathering systems). Duke argued that its gathering systems were includible in class 13.2 because "gathering systems" are specifically mentioned in asset class 13.2, the gathering systems are "used by" petroleum and natural gas producers to produce natural gas, and the gathering systems are essential to the production and sale of gas in the market. The Service argued that to be includible in a particular asset class, the taxpayer with the depreciable interest in the property must itself be engaged in the described business activity. While the lower court held in the Service's favor, finding that Duke transports, rather than produces, gas, this decision was reversed by the 10th Circuit, which held that the gathering systems were assets "used by" producers in the exploration for and production of petroleum and natural gas deposits. We believe the present case is very similar to Duke in that Taxpayer can argue that "support vessels" are specifically mentioned in asset class 13.0 and are an integral part of offshore drilling. Although we are pleased that Duke was described as "wrongly decided" by the court in Saginaw Bay Pipeline Company v. United States, No. 99-70454 (E.D. Mich., August 23, 2001), [REDACTED]

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POSTF-154902-01

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Supplement II, 1963-2 C.B. 744, which consists of Questions and Answers, was published to assist taxpayers in applying Rev. Proc. 62-21. We note that Answer 78 provides a primary-use rule for the classification of assets used in more than one business activity similar to the rule found in section 1.167(a)-11(b)(4)(iii)(b). Answer 78 further provides that primary use may be determined in any reasonable manner. In Rev. Proc. 97-10, 1997-1 C.B. 628, either a gross-receipts test or a square-footage test can be used to determine whether a building is primarily used as a retail motor fuels outlet. In light of this precedent, Taxpayer may be able to establish primary use for a particular vessel in terms of days chartered, income earned, the number of time charterers for the year engaged in a particular activity, or some other basis.

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If you have any questions regarding this Field Service Advice, please call (202) 622-3110.

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