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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR William R. Pfeil

Acting LMSB TA2 Manager & Shipping Technical Advisor

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 supplements the advice previously issued in this case on February 13, 2002. 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 subsidiary operating companies and then time-chartered pursuant to service contracts to unrelated companies in the offshore energy industry 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 subsidiary operating companies and are includible in asset class 00.28 of Rev. Proc. 87-56, 1987-2 C.B. 674.

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FACTS

Taxpayer owns offshore supply vessels and marine support vessels that are used to support all phases of offshore energy exploration, development and production, including: (1) towing of and anchor handling of mobile drilling rigs and equipment; (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 subsidiary operating companies. The boat-owning companies enter into bareboat charters with operating companies that they control, pursuant to which the operating company 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, 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.

In the Chief Counsel Advice previously issued in this case we concluded that Taxpayer's vessels are classified for depreciation purposes in accordance with the business activities of the particular time charterers to whom they are chartered. Implicit in the analysis we used to reach this conclusion was the assumption that both the bareboat charters and the time charters used with respect to Taxpayer's vessels were leases for federal income tax purposes. You have asked us to consider whether our conclusion would be different if the time charters were determined to be service contracts rather than leases for federal income tax purposes.

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 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.

Section 1.167(a)-11(e)(3)(iii) 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.

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

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(2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. An item of depreciable property that falls within 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), is classified in the asset category unless specifically described in the activity category. See Norwest Corporation & Subsidiaries v. Commissioner, 111 T.C. 105 (1998) (an asset that falls within both an asset and an activity category 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 asset class 00.28 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 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. 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 44.0, Water Transportation, includes assets used in the commercial and contract carrying of freight and passengers by water except the transportation assets included in classes with the prefix 00.2. Assets in this class have a recovery period of 15 years for purposes of section 168(a) and 20 years for purposes of section 168(g).

Asset class 57.0, Distributive Trades and Services, includes assets used in wholesale and retail trade, and personal and professional services. Assets in this class have a recovery period of 5 years for purposes of section 168(a) and 9 years for purposes of section 168(g).

Under section 168 and Rev. Proc. 87-56, a taxpayer's assets are classified for depreciation purposes in accordance with the taxpayer's business activity (asset classes 01.1 through 80.0), unless the assets are included in a specific asset class (asset classes 00.11 through 00.4). For property to be included in a business

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activity asset class, the taxpayer with the depreciable interest in the property must itself be engaged in the business activity described by the asset class.

In the present case, Taxpayer depreciates its vessels as assets includible in asset class 13.0, Offshore Drilling. However, Taxpayer's business activity of chartering 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) indicates that the depreciation classification of Taxpayer's vessels is determined by looking to the business activities of Taxpayer's operating companies/lessees. Because we are, pursuant to your request, assuming that the time charters used with respect to Taxpayer's vessels are service contracts rather than leases for federal income tax purposes, the lease rule provided by section 1.167(a)-11(e)(3)(iii) does not operate to shift the focus of our inquiry from the business activities of the operating companies to the business activities of the time charterers. Compare Hauptli v. Commissioner, 902 F.2d 1505 (10th Cir. 1990), where, in a lease and sublease factual setting, the court concluded that it would look to the activities of the end-user sublessees for purposes of depreciation classification.

Clearly, the operating companies are not themselves engaged in offshore drilling (asset class 13.0) or marine contract construction (asset class 15.0). These asset classes are the only business activity asset classes that include vessels. Asset class 13.0 specifically includes vessels used in offshore drilling in its description. With regard to asset class 15.0, the historical evolution of that class and the descriptive language of asset class 00.28, which specifically excludes vessels used in marine construction, indicate that vessels used in marine construction are included in asset class 15.0.

Based on the limited facts submitted with your request for Chief Counsel Advice, we have concluded that the subsidiary operating companies' business activities are described in asset class 44.0, Water Transportation, or asset class 57.0, Distributive Trades and Services. Asset class 44.0 includes assets used in the commercial and contract carrying of freight and passengers by water, except for the transportation assets included in asset classes beginning with the prefix 00.2. The subsidiary operating companies in many instances transport people, supplies, and equipment to offshore facilities. These activities appear to fall within the scope of asset class 44.0. However, asset class 57.0 includes assets used in the provision of various services. Because the subsidiary operating companies provide many types of vessel services pursuant to service contracts, an argument can be made that these companies' business activities are described in asset class 57.0. Further, we note that section 1.167(a)-11(b)(4)(iii)(b) indicates that taxpayers can be engaged in more than one business activity. Thus, the subsidiary operating

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companies may be engaged in business activities described in asset class 44.0 and asset class 57.0.

As previously discussed, the only business activity asset classes that include vessels are classes 13.0 and 15.0. Therefore, whether the subsidiary operating companies' business activities are described in asset class 44.0, asset class 57.0, or both, vessels used in these activities are includible in asset class 00.28. Asset class 44.0 specifically excludes transportation assets included in asset classes beginning with the prefix 00.2. Therefore, classifying Taxpayer's vessels for depreciation purposes in accordance with the subsidiary operating companies' business activities, the vessels are includible in asset class 00.28.

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 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]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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[REDACTED]

For purposes of this Chief Counsel Advice we have assumed that the time charters are service contracts for federal income tax purposes. However, the determination of whether a particular time charter is a lease or service contract requires an intensive analysis of all the facts and circumstances surrounding the transaction. The legislative history of section 7701(e)(1) indicates that time charters can be leases. See S. Rep. No. 169 (vol. 1), 98th Cong., 2d Sess. 136-40 (1984). If a court concludes that a particular time charter is a lease for federal income tax purposes, the analysis set forth in the Chief Counsel Advice previously issued would be applicable. The primary use considerations discussed in the Hazards section of that advice also would be germane.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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

Mark Pitzer

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