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Courier's Desk
Internal Revenue Service
CC:PA:LPD:PR (REG-104397-18)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Regulations Under Section 168(k) (REG-104397-18)

Dear Sir or Madam:

On behalf of the Energy Tax Group of Eversheds Sutherland (US) LLP, we respectfully submit these comments with respect to proposed regulations (the "Proposed Regulations") issued on August 8, 2018, and published in the Federal Register on that same date (83 Fed. Reg. 39292) under section 168(k) of the Internal Revenue Code of 1986, as amended by Pub. Law 115-97[1] (the "Code") regarding the revised "additional first year depreciation deductions." Although our comments may have broader implications to other industries, they are principally offered from the perspective of regulated electric, gas, and water companies, many of which our firm represents in a number of capacities. Nevertheless, these comments are made not in a representative capacity, but solely to offer our suggestions on the manner in which the Proposed Regulations can be clarified and improved.

Many of the participants in the electric, gas and water industries are regulated by either state ratemaking bodies, federal ratemaking bodies, or both (hereinafter referred to for convenience as "regulated energy companies"). For regulated energy companies, it is generally true that certainty of tax treatment is of paramount importance. That is the case because although regulated energy companies are allowed to recover taxes from their customers (based upon a test year), they are generally not allowed to recover any tax shortfalls that arise if a position taken on their tax return is later successfully challenged by the tax authorities. This is commonly known as the "prohibition against retroactive ratemaking." In other words, unlike unregulated taxpayers, absent regulatory approval and subject to the prohibition against "retroactive ratemaking," regulated energy companies cannot simply raise prices to customers should they erroneously apply the tax laws. Accordingly, certainty of tax treatment takes on heightened significance for regulated energy companies seeking to comply with the tax laws.

Similarly, providing tax "elections" to regulated energy companies is not as helpful as it might superficially seem, particularly when compared to unregulated companies. Often, regulated energy companies will either be required to obtain regulatory pre-approval

[1] Pub. Law 115-97 is often referred to as the "Tax Cuts and Jobs Act" or "TCJA".

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of a tax election or, if between rate cases, must be prepared to explain to regulators after the fact how the election made was in the best interests of ratepayers. Such determinations are sometimes challenging given the competing interests of stakeholders. Consider, for example, a regulated energy company with years of accumulated net operating losses as a result of bonus depreciation, a very common fact pattern in the industry. One might have expected that those companies would have elected out of bonus depreciation to minimize the risk of net operating losses expiring under the law in effect prior to the TCJA. But very few regulated energy companies made such elections because of the potential perception that the companies were not acting in the best interests of ratepayers by choosing not to maximize available tax benefits, even though the generation of additional net operating losses by claiming additional bonus depreciation would not benefit current ratepayers.[2]

With these general principles in mind, we now turn to the various areas where the regulated energy companies would benefit from additional clarification. Our comments are divided into two main sections. First, our comments address certain aspects of the Proposed Regulations where the guidance is clear, but we believe alternative policy choices should have been made. Second, we set forth several of fact patterns that we believe are not clearly addressed in the Proposed Regulations and should be addressed in the final regulations. Again, as previously noted, although we offer our views on the appropriate treatment of these fact patterns, ultimately, having clear guidance is as important as the particular tax treatment ultimately prescribed in the final regulations.

1. Areas of Alternative Policy Choices

A. 2017 Expensing Eligibility

It is generally understood that regulated energy companies, *inter alia*, accepted ineligibility for expensing under new section 168(k) and, in return, were excluded from the interest limitation provisions under new section 163(j). Given that the effective date of new section 168(k) was September 27, 2017, prior to the issuance of the Proposed Regulations we believed, and we understand that the vast majority of regulated energy companies believed, that they would be ineligible for expensing as of that date. However, as the preamble to the Proposed Regulations correctly observes, the definition of trades or businesses excluded from expensing eligibility under section 168(k) is not contained in that subsection. Rather, it is contained in section 163(j) as amplified in forthcoming Proposed Regulations to be issued under that provision. However, the effective date of new section 163(j) was not until January 1, 2018.

In light of the inconsistent effective dates of the respective provisions, the Proposed Regulations deem property acquired by regulated energy companies after September 27, 2017 and placed in service prior to January 1, 2018 to be eligible for expensing. Although we acknowledge that the statute can be literally interpreted in this matter, we respectively submit that Treasury could and should have concluded otherwise. First, the definition of the excluded trade or business of regulated energy companies incorporated in new section 163(j) is not new. It is essentially the same definition used for purposes of the normalization provisions of the Code under sections 167, 168 and 46 and the regulations

[22] The Internal Revenue Service has frequently ruled that the deferred taxes attributable to the accelerated depreciation component of net operating losses may not be used to reduce rate base unless and until the net operating losses are used to reduce taxable income. *See, e.g.*, PLRs 201418024, 201436037, 201436038, 201438003, 201519021, 201534001, and 201548017.

thereunder, as well as the myriad of private letter rulings interpreting those provisions. Under all of that guidance, property is public utility property (and presumably the trade or business in which it is used is a regulated energy trade or business) if it is subject to the ratemaking jurisdiction of a federal or state ratemaking body and the rates are established or approved by such bodies on a cost of service/rate of return basis.[3] Indeed, Treas. Reg. Sec. 1.46-3(g)(2)(iii) is set forth in full below:

> A taxpayer's rates are "regulated" if they are established or approved on a rate-of-return basis. Rates regulated on a rate-of-return basis are an authorization to collect revenues that cover the taxpayer's cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services, where the taxpayer's costs and investment are determined by use of a uniform system of accounts prescribed by the regulatory body. A taxpayer's rates are not "regulated" if they are established or approved on the basis of maintaining competition within an industry, insuring adequate service to customers of an industry, or charging "reasonable" rates within an industry since the taxpayer is not authorized to collect revenues based on the taxpayer's costs of providing goods or services.

Similarly, the definition of a "regulated public utility" in section 7701(a)(33) embraces the same concepts. Thus, it is readily apparent that new section 163(j) did not create a new definition of the trade or business of a regulated energy company; it simply incorporated the existing definition that was well established under prior law into section 163(j) for purposes of that section and for a cross-reference from section 168(k).[4] Viewed in this light, and the expectations of affected parties given the September 27, 2017 effective date for section 168(k), Treasury could and should have concluded, that section

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[3] Recognizing that for certain companies in certain jurisdictions, the relevant regulatory agencies do not necessarily act to "establish or approve rates," such that filed tariffs go into effect unless and until the regulatory body acts to change them, Treas. Reg. Sec. 1.167(l)-1(b)(1) provides that rates are "established or approved" if they are reflected in rate filings with a regulatory body that has the power to approve such rates even if it does not exercise that power and leaves undisturbed the rates filed by the taxpayer. *See also*, Treas. Reg. Sec. 1.46-3(g)(2)(iii) (last sentence). Rates are not determined on a cost of service/rate of return basis, and the property will not be public utility property if the rates charged to customers are freely negotiated, based on a market index, a spot price or avoided cost. *See, e.g.*, Rev. Rul. 82-109. 1982-1 C.B. 7 (where rates charged by PURPA qualifying facility were based on avoided costs not the cost of service of the facility, the property was not public utility property). *See also*, PLR 201544018 (Oct. 30, 2015) (solar property subject to negotiated rates between utility and governmental agencies was not public utility property); PLR 201825025 (Mar. 8, 2018) and PLR 201825026 (Mar. 8, 2018) (use of market based rates based on competitive procurement data precludes classification of solar facility as "public utility property." The portion of the facility that uses cost of service/rate of return pricing is public utility property.)

[4] Although arguably more appropriately addressed in the forthcoming Proposed Regulations under section 163(j) we understand that questions have arisen whether property leased to a regulated energy company and used in its trade or business is eligible for expensing. Essentially, the question is "whose trade or business controls," the lessor (e.g., a financial institution) or the lessee (the regulated energy company)? We would suggest that Treasury adopt the approach of Treas. Reg. Sec. 1.46-6(g)(3) in treating property leased to and used by a regulated energy company as "public utility property" ineligible for expensing. That approach would also be consistent with cases holding that the "use" of the property, not the "user," controls its classification for depreciation purposes. See *Duke Energy Natural Gas Corp. v. Comm'r, 172 F.3d 1255* (10th Cir. 1999); *Saginaw Bay Pipeline Co., v. United States,* 338 F.3d 600 (6th Cir. 2003); *Clajon Gas Co. v. Comm'r,* 354 F.3d 786 (8th Cir. 2004). See also, Treas. Reg. Sec. 1.167(l)-1(b)(2) (the classification of property is based on its "predominant use," as determined by the classification of property in its system of regulated accounts.) The Proposed Regulations will still need to define "predominant use," or alternatively a *de minimis* rule whereby minor uses of property will not affect the overall classification of the trade or business.

163(j)(7) is not a substantive provision, but rather a definitional provision consistent with existing law, and thus property acquired after September 27, 2017 and used in a regulated energy business is ineligible for expensing.

B. Interplay between the binding contract rule and the self-constructed property rule

Except for one limited purpose, new section 168(k) does not specifically address the interplay between property subject to the written binding contract rule and property subject to the self-constructed property rule. More specifically, again with one limited exception, it does not specify whether property constructed for the taxpayer under a written binding contract that would have been self-constructed property if constructed by the taxpayer is to be treated as subject to the binding contract rule or the self-constructed rule. The limited exception pertains solely to the long production period rules of section 168(k)(2)(B) and (E). Under section 168(k)(2)(B)(III), property is treated as qualified long production property eligible for expensing if it is acquired by the taxpayer (or acquired pursuant to a written binding contract entered into) before January 1, 2027.[5] Under section 168(k)(2)(E), for purposes of this long production property rule, property constructed by the taxpayer for the taxpayer's own use is treated as acquired by the taxpayer if it begins manufacturing, construction or production prior to January 1, 2027. Even if the interplay of these rules creates a negative inference that for purpose of long production period property the binding contract rule overrides the self-constructed property rule when property is constructed on behalf of the taxpayer by another, we do not believe there is any basis for extrapolating and extending that rule to all self-constructed property constructed for the taxpayer under a binding contact. Rather, we believe that absent clear and unmistakable Congressional intent to the contrary, it should be assumed that Congress was well aware of the long-standing interrelationship between the two rules and intended to treat such property as self-constructed property, not binding contract property. *See* Treas. Reg. Sec. 1.168-1(b)(4)(iii)(B).[6] The final regulations should provide that property, other than long production period property, constructed for the taxpayer under a written binding contract that would have been self-constructed property if constructed by the taxpayer is to be treated as subject to the self-constructed rule.

2. Fact Patterns Requiring Greater Clarification

Many of the challenges arising under the Proposed Regulations are attributable to the fact that in many ways the TCJA, and the so-called technical corrections provisions to the Protecting Americans from Tax Hikes Act of 2015 which were enacted as Division Q of the Consolidated Appropriations Act of 2016, P.L. 114-113, did not clearly articulate the manner in which Congress intended the "old 168(k) regime" which continues in effect should co-exist with property governed by "new section 168(k)." The problem is further exacerbated by the failure of Congress to statutorily provide a basis allocation rule for costs incurred at different times during which the substantive 168(k) rules provided disparate treatment.

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[5] Only the basis attributable to costs incurred for manufacturing, construction or production prior to January 1, 2017 is so eligible. Section 168(k)(2(B)(iii).

[6] The adoption of the "binding contract rule trumps the self-constructed property rule" approach creates a secondary problem discussed more fully in section 2B, below.

A. Pre-September 28, 2017 binding contract property placed in service after December 31, 2018

As noted earlier, one of the flaws of the statutory scheme is that with the limited exception of the rule for certain long production property, unlike prior iterations of bonus depreciation, there is no specific basis allocation rules that divides the cost of property amongst these various potentially applicable situations. In the case of binding contract property, Prop. Reg. Sec. 1.168(k)-2(b)(5) provides that property subject to a binding contract is treated as "acquired" as of the date of the written binding contract. However, does that imply that all costs incurred in connection with that acquisition are treated as "incurred" as of the date of the binding contract deemed "acquisition date"? If so, the net effect of that rule is that costs incurred during an expensing eligible period under the Proposed Regulations (September 27 - December 31, 2017) would be eligible for bonus depreciation under the "old rules," with the eligible percentage determined by the placed in service year, and costs incurred after December 31, 2017 would still be eligible for bonus depreciation (versus MACRS) even though the regulated energy companies are exempted from the application of section 163(j) as of January 1, 2018, which seems clearly contrary to the statutory scheme. Whether a technical correction is needed or whether Treasury has the authority to adopt a basis allocation rule or to limit eligible costs to costs incurred prior to January 1, 2018 is beyond the scope of these comments. In the interest of providing clarity to regulated energy companies, Treasury should clarify its position with respect to these situations in any event.

B. Self-constructed property

Although it is not entirely clear, and examples demonstrating these rules would be helpful, it would seem that under the Proposed Regulations, self-constructed property commenced after September 27, 2017 and placed in service prior to December 31, 2017 is eligible for expensing. Self-constructed property the construction of which commences after December 31, 2017 is not "qualified property" and thus should only be eligible for MACRS. For self-constructed property the construction of which commenced after September 27, 2017 and that is placed in service after December 31, 2017, we believe the final regulations should clearly provide that MACRS is the maximum depreciation allowance for regulated energy companies. In the absence of a basis allocation rule, the project should clearly be governed by "new 168(k)" and since the binding contract rule does not apply, the placed in service date is after December 31, 2017 when section 163(j) is fully operational and regulated energy property is no longer section 168(k) qualified property, no form of bonus depreciation, but instead only MACRS, should be allowable.

If the final regulations retain the current override of the self-constructed property rule by the binding contract rule, the final regulations need to specify the results they intend to obtain if the contract to manufacture or construct property on behalf of the taxpayer fails to satisfy the requirements of a binding contract under the Proposed Regulations. For example, if the contract is unenforceable under state law, or has a disqualifying liquidated damages clause, it is not treated as a binding contract under the Proposed Regulations. Is the property still subject to the binding contract rules or does it default to the self-constructed property rules? Again, as noted above, certainty of result rather than a particular result is of paramount importance.

Public Hearing

We hereby request an opportunity to provide public testimony at any hearing on the Proposed Regulations.

Respectfully submitted,

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