

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

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date: May 10, 2006

to: Internal Revenue Service
Attn: Manager

from: Associate Area Counsel (Cleveland)
(Large & Mid-Size Business)

subject: Request for Advisory Opinion
Parent
Re: Prepayment of Electricity Discounts under Amended Power Purchase Agreement

This memorandum responds to your request for assistance dated October 17, 2005. This advice should not be used or cited as precedent.

Manager	=	
Parent	=	
taxpayer	=	
seller	=	
date 1	=	
date 2	=	
xx	=	
date 3	=	
date 4	=	
yy	=	
date 5	=	
Board	=	
date 6	=	
date 7	=	
zz	=	
date 14	=	

date 8	=	
date 9	=	
AA	=	
BB	=	
CC	=	
date Q	=	
date 12	=	

Issue

Whether the prepayment of electricity discounts by the seller of electricity to the taxpayer-purchaser constitutes ordinary income or capital gain?

Conclusion

The prepayment of electricity discounts constitutes ordinary income.

Statement of Facts

Taxpayer and seller entered into a Power Purchase Agreement (“PPA”) effective as of date 1. Pursuant to the PPA, seller agreed to sell, and taxpayer agreed to buy, the power output of a specific cogeneration facility (the “Facility”). The term of the PPA was to run for 20 years from the initial delivery date of power from the Facility, which occurred in date 2. The PPA provided that taxpayer agreed to purchase from seller up to xx megawatt hours (“MWH”) per year of electric energy. Taxpayer’s obligation to accept electricity from seller was limited to electricity generated from the Facility.

The Facility was a qualifying facility (QF) under the Public Utility Regulatory Policy Act of 1978 (PURPA). PURPA required public utilities to purchase power from these qualifying facilities at avoided cost rates which turned out to be higher than market rates.

In date 3, taxpayer and seller began discussing a possible long-term restructuring of the PPA. The proposal was for seller to be able to sell electricity from sources other than the Facility. In return for seller’s delivery flexibility, taxpayer would receive a discount.

On date 4, taxpayer and seller entered into an Amended and Restated Power Purchase Agreement (the “Amended PPA”). In a nutshell, the Amended PPA contains energy price discounts from an expected “base” price, with such “base” price structured to equal the expected prices under the existing PPA, with seller having an option to

prepay part or all of such discounts under certain conditions. The expected value of the discounts was approximately \$yy. The Amended PPA gives seller the flexibility to provide power to taxpayer from the Facility or from other sources. The term of this agreement was to continue through date 5, the existing termination date.

Seller filed a petition with the Board, on date 6, requesting approval of the restructured contract.

On date 7, the Board approved the Amended PPA. The Amended PPA permitted seller, at its sole option, to pay upfront the projected energy discount under the Amended PPA, in the form of a NPV Prepayment Credit, payable in whole or in part to taxpayer, within three years after the effective date of the Amended PPA.

During the course of the proceeding with the Board, seller committed to making a Prepayment Credit payment of approximately \$zz to taxpayer on the effective date of the Amended PPA. That commitment was memorialized in a letter agreement between taxpayer and seller dated date 14, wherein seller assumed the effective date of the Amended PPA to be date 8, as originally contemplated in the petition.

On date 9, the Amended PPA became effective and binding. Seller prepaid AA% of the \$BB minimum energy discount per MWH through a payment to taxpayer equal to approximately \$zz. The balance of the discount savings, expected to be approximately \$CC, was to be realized over the life of the contract.

Taxpayer reported the prepayment received as long-term capital gain on its date Q federal income tax return.

Law and Analysis

I.R.C. § 61(a) defines gross income as all income from whatever source derived. The amount of any item of gross income is included in the taxable year received, unless, under taxpayer's method of accounting, such amount is properly accounted for as of a different period. § 451(a). Under taxpayer's method of accounting, i.e., the accrual method, payments are included in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Treas. Reg. § 1.451-1(a).

In the subject case, taxpayer received the \$zz payment in date 12. No dispute existed as to the taxpayer's right to those funds. Accordingly, because taxpayer had

unrestricted use of those funds, they were taxable upon receipt.¹

Since the taxpayer is taxable upon receipt of the subject funds, the issue arises as to the characterization of the income, i.e., ordinary or capital. Although taxpayer agrees that the payment is includable in income, it argues that the payment gives rise to capital gain. Specifically, taxpayer argues that a payment in exchange for the modification of a contract through the removal of a specific provision (whether it be a restrictive clause or an exclusive right of one of the parties) will give rise to capital gain. Here, the payment purportedly was in exchange for the removal of a restrictive clause, i.e., the clause limiting seller to supplying power from the Facility, and should give rise to capital gain.

We disagree. Taxpayer mistakenly argues that the payment was in exchange for the removal of the restrictive clause limiting seller to supplying energy from one source. The facts do not support taxpayer's position.

The original PPA did restrict seller to one energy supply source. The Amended PPA removed this restriction and lowered taxpayer's energy payment to the seller by a stated discount amount. The subject payment was not made in exchange for the modification of the original PPA.² Under the Amended PPA, seller could have chosen to sell electricity, from more than one source, at the agreed-on discount of \$BB. Instead, seller chose to make an upfront payment to reduce the discount and thereby increase the price of its electricity sold to taxpayer. The character of the gain is fixed by reference to the underlying transaction, which in this case is ordinary in nature, i.e., the Amended PPA governed the sale of electricity which is inventory in the taxpayer's hands.³ See § 1221(a)(1); Arrowsmith v. Commissioner, 344 U.S. 6 (1952); Smith v.

¹ Since the advance discount did not arise contemporaneously with the purchase of specific goods, it cannot be treated as a trade discount. See Westpac Pacific Goods v. Commissioner, T.C. Memo. 2001-175.

² Even if the payment resulted in the removal of the restrictive covenant or the termination of the original PPA, the gain arguably would still be ordinary not capital. In order for the termination payment to qualify for capital gain treatment, it must result from the sale or exchange of a capital asset within the meaning of §§1221 and 1231. The taxpayer would still have the burden of proving that (1) the payment was in exchange for the restrictive covenant and not for the termination of the prior contract; (2) the restrictive covenant was a capital asset; and (3) the transaction resulted in a sale or exchange. Under the extinguishment doctrine, payments received for the cancellation or termination of contractual or similar rights do not qualify for capital gain or loss treatment because the rights are not sold to, or exchanged with, the payor; instead, they simply cease to exist. The Service's position is that the extinguishment doctrine still applies in situations not covered by statutory provisions such as § 1234A. See, e.g., Rev. Rul. 75-527, 1975-2 C.B. 30; authorities discussed in TAM 200427025; PLR 200215037. But see Turzillo v. Commissioner, 346 F.2d 884 (6th Cir. 1965). Although we have noted these additional arguments, the Field has not requested advice on these issues.

³ For a discussion as to why electricity is inventorial, see the authorities discussed in PLR 200152012.

Commissioner, 48 T.C. 872, 880 (1967), aff'd in part and rev'd in part on another issue, 424 F.2d 219 (9th Cir. 1970); Wener v. Commissioner, 24 T.C. 529 (1955), aff'd, 242 F.2d 938 (9th Cir. 1957).

In Arrowsmith, two stockholders decided to liquidate their corporation. Partial distributions were made during 1937 through 1939, and a final distribution was made in 1940. The stockholders reported the profits obtained from these distributions as capital gain. A judgment subsequently was rendered against the corporation in 1944, and the stockholders were required to pay the judgment as transferees of the corporate assets. The stockholders claimed an ordinary business loss for the judgment paid. The Supreme Court found the law clear that liquidating distributions are treated as capital exchanges. The Court also found it clear that the loss was not incurred as a result of an ordinary business transaction apart from the liquidation proceedings. Accordingly, the Court found that the stockholders incurred a capital loss.

In Smith, the corporation in an earlier year had reported the sale of acres of timberland as capital gain. The purchaser exercised its option in the following fiscal year to prepay the purchase price at a discount. The Tax Court rejected the taxpayer's attempt to characterize the discount as an ordinary loss. The court looked to the original transaction, which was capital in nature, and treated the corporation's loss as capital. Smith, 48 T.C. at 880.

Similarly, in Wener, the taxpayers agreed to sell their interests in a partnership in return for several installments. As a result of further negotiations, they received a lump-sum payment later the same year in lieu of the installments. The courts held that the taxpayers were not entitled to an ordinary loss as a result of this up-front payment, because the underlying transaction was the sale of a capital asset. Although cases relying on Arrowsmith typically involve a relationship between events occurring in different years, both courts in Wener cited Arrowsmith as authority, even though the payment was made in the same year as the underlying transaction.⁴

In the subject case, the transaction set forth in the Amended PPA involves the sale of electricity, which is inventorial by the taxpayer. The subsequent sale of the purchased electricity clearly results in ordinary income. Because the original transaction from which the payment arose, i.e., the Amended PPA, was ordinary in nature, so is the upfront payment. The following example helps illustrate the nature of the underlying transaction. As in Wener, the fact that the payment occurred in the same year as the Amended PPA only warrants more readily the conclusion that it must be

⁴ See 242 F.2d at 947, n. 30 ("[T]he fact that the reduction in price ... took place in the same taxable year, warrants more readily the conclusion that it must be related to the agreement from which it stemmed ...").

related to the underlying transaction from which it stemmed. The following example helps illustrate the nature of the underlying transaction.

Assume seller agreed to sell electricity, from any source, to the taxpayer for a total of \$3 dollars/year during the next 5 years. Under an amended PPA, seller could make an upfront \$10 payment to receive \$5 dollars per year, instead of \$3. Whether or not the payment is made has no effect on seller's right to sell electricity from other sources. If the upfront payment is not made, taxpayer pays a total of \$15 for electricity and has a \$15 basis in the electricity. If taxpayer resells the electricity for \$30, taxpayer recognizes \$15 of ordinary income. On the other hand, if seller pays the \$10 upfront, taxpayer pays the higher rate and has a total \$25 basis in the electricity purchased. If taxpayer resells the electricity for the same \$30, it only has \$5 of ordinary income. The upfront \$10 payment must be treated as ordinary income to treat the transactions consistently. Taxpayer would like to treat the upfront payment as capital gain. This would produce the incongruous overall result of \$5 ordinary income and \$10 capital gain. The manner in which seller chooses to sell the electricity should not result in the effective conversion into capital gain of \$10 of ordinary income on the taxpayer's purchase and resale of inventory.

In conclusion, the prepayment of electricity discounts in this case constitutes ordinary income.

RICHARD S. BLOOM
Associate Area Counsel
(Large & Mid-Size Business)

By: _____
Marc A. Shapiro
Senior Attorney
(Large & Mid-Size Business)