

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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CC:TEGE:EOEG:TEB-PLR-122359-03

Date:

June 27, 2003

Legend:

Issuer =

Holding Company =

S1 =

S2 =

Electric Company =

Bonds =

Facilities =

State =

PLR-122359-03

Authority =

Service Area =

a =Date 1 =Date 2 =Date 3 =Year 1 =New Electric
Company =U =City X =Power Supply
Agreement =Power Purchase
Agreement =

Commission =

Act =

PLR-122359-03

Cite 1 =

This letter is in response to a request on behalf of the Issuer and the Holding Company for rulings that (a) S1, a subsidiary of the Holding Company, is a successor in interest to Electric Company for purposes of § 142(f)(3)(B) of the Internal Revenue Code of 1986 (the “Code”)¹ and (b) the Facilities, as described below, will serve or are available on a regular basis for general public use within the meaning of § 1.103-8(a)(2) and § 1.103-8(f)(1) of the Income Tax Regulations.

Facts and Representations:

Issuer, an agency of the State, is authorized under State law to issue bonds for financing certain manufacturing, industrial and commercial facilities. Issuer proposes to issue bonds (the “Bonds”) and loan the proceeds to the Holding Company and its subsidiaries to reimburse certain construction costs of Facilities located in the State. The Facilities were placed in commercial operation on Date 1. The Issuer adopted on Date 2 a resolution taking official action towards the issuance of the Bonds for the Facilities. The Issuer represents that it expects to reimburse certain expenditures made by the Holding Company with respect to the Facilities with the Bond proceeds in compliance with § 1.150-2.

The Facilities are owned and operated by S1. The Holding Company represents that the Facilities will be property of a character subject to the allowance for depreciation provided in § 167.

Electric Company was a corporation organized under the laws of the State and a regulated public utility within the meaning of § 7701(a)(33). Electric Company operated an integrated system of generating, transmission and distribution facilities for electric energy (the “Local Electric System”) that provided electric energy to customers (the “Customers”) within the Service Area. It is represented that as of Date 3, Electric Company continued to be engaged in the local furnishing of electric energy. Electric Company also operated a natural gas distribution business within the Service Area. Electric Company’s assets consisted of various electric utility assets including fossil fuel generating plants, an interest in nuclear generating property, an electric transmission and distribution system, a gas distribution system, and other assets related to its

¹ Unless otherwise specified, references to the Internal Revenue Code are to the Internal Revenue Code of 1986.

PLR-122359-03

electric and gas businesses. Electric Company received two private letter rulings that its facilities at the time were facilities for the local furnishing of electric energy within section 142(a)(8) and in one of those rulings, Electric Company's local system was found to be a system providing service to the general populace of the geographical service area as required under § 142(f)(1). Ltr. 8508051 (November 27, 1984) and Ltr. 9447031 (August 25, 1994).

U was a regulated public utility that distributed gas to customers in City X. Authority is a political subdivision of the State, created by the State legislature.

Restructuring

Sometime in or before Year 1, U, Electric Company and Authority entered into negotiations to restructure so that Authority would acquire certain electric utility assets owned by Electric Company and U would combine with Electric Company under a single holding company, referred to herein as the Holding Company. In connection with the combination of U with Electric Company and as a result of the restructuring, Electric Company pre-transaction shareholders owned a percent of the Holding Company.

Transfer of Non-Nuclear Electric Generating Assets

Electric Company transferred its gas utility assets, non-nuclear electric generating assets and its common plant to Holding Company which in turn transferred the assets to its subsidiaries. The non-nuclear electric generating assets are referred to below as the "Transferred Generating Assets". Electric Company retained its electric transmission and distribution system and its ownership interest in a nuclear generating facility (the "Retained Transmission and Distribution Assets").

Transfer of Retained Transmission and Distribution Assets

A newly formed subsidiary of Authority merged with Electric Company, with Electric Company as the surviving corporation (referred to as "New Electric Company"). New Electric Company became the wholly owned subsidiary of Authority. Following the merger, New Electric Company's assets consisted of the Retained Transmission and Distribution Assets. The restructuring was completed on Date 3.

Holding Company and its subsidiaries agreed to supply Authority and New Electric Company with electricity from the Transferred Generating Assets under the Power Supply Agreement so that Authority and New Electric Company could provide electricity to the Customers in the Service Area. The Power Supply Agreement was subject to the approval of the Commission and the Federal Energy Regulatory Commission ("FERC").

PLR-122359-03

Operation Since the Restructuring

S1 currently owns and operates the Transferred Generating Assets formerly owned by Electric Company and transferred to Holding Company. New Electric Company owns the Retained Transmission and Distribution Assets. S1 provides all of the output from the Transferred Generating Assets to Authority and New Electric Company under the Power Supply Agreement. It is represented that the area served by the Retained Transmission and Distribution Assets and the Transferred Generating Assets is the same as the Service Area and that Authority and New Electric Company provide service only to the Customers within the Service Area.

The Holding Company represents that S2 will be a wholly-owned subsidiary of S1. S2 will sell all of the output generated at the Facilities to New Electric Company and Authority pursuant to the Power Purchase Agreement during the term of the agreement. The agreement states the legal maximum capacity at which the Facilities must be run and provides that during its term New Electric Company will have exclusive rights to the output. The agreement also provides that all metering devices required for measuring the output of the Facilities will be installed on New Electric Company's side of the delivery point and will be owned and operated by New Electric Company. The term of the Power Purchase Agreement is 25 years from Date 1.

Law and Analysis:

Section 142(a)(8) provides that "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide facilities for the local furnishing of electric energy or gas. For purposes of § 142(a)(8), § 142(f)(1) provides that the local furnishing of electric energy or gas shall consist of furnishing solely within an area consisting of a city and one contiguous county, or two contiguous counties.

Section 1.103-8(a)(2) provides in part that in order to qualify as an exempt facility for purposes of § 103(b)(4) and thus § 142(a), a facility must serve or be available on a regular basis for general public use, or be a part of a facility so used, as contrasted with similar types of facilities which are constructed for the exclusive use of a limited number

PLR-122359-03

of nonexempt persons in their trades or businesses.²

Section 1.103-8(f)(1)(i) states the standard that a facility for the local furnishing of electric energy must meet in order to satisfy the public use test of § 1.103-8(a)(2). Section 1.103-8(a)(f)(1)(i) provides that a facility for the local furnishing of electric energy or gas will satisfy the public use requirement of § 1.103-8(a)(2) only if such facility, or the output thereof, is available for use by members of the general public.

Section 1.103-8(f)(2)(ii) provides one way that a facility will be deemed to have met the public use requirement of § 1.103-8(a)(2). Section 1.103-8(f)(1)(ii) states that a facility for the local furnishing of electric energy or gas is available for use by the general public if (a) the owner or operator of the facility is obligated, by a legislative enactment, local ordinance, regulation, or the equivalent thereof, to furnish electric energy or gas to all persons who desire such services and who are within the service area of the owner or operator of such facility, and (b) it is reasonably expected that such facility will serve or be available to a large segment of the general public in such service area.

Section 1.103-8(f)(2)(iii) provides that the term “facilities for the local furnishing of electric energy or gas” means property which –

- (a) Is either property of a character subject to the allowance for depreciation provided in section 167 or land;
- (b) Is used to produce, collect, generate, transmit, store, distribute, or convey electric energy or gas;
- (c) Is used in the trade or business of furnishing electric energy or gas; and
- (d) Is a part of a system providing service to the general populace of one or more communities or municipalities, but in no event more than two contiguous counties (or a political equivalent) whether or not such counties are located in one State.

A facility for the generation of electric energy otherwise qualifying under this subdivision will not be disqualified because it is connected to a system for interconnection with other utility systems for the emergency transfer of electric energy.

Successor in Interest

² To the extent not amended, Congress intended that principles of law under the 1954 Code continue to apply under the Code. H.R. Conf. Rep. No. 99-841 at II-686, 1986-3 (Vol. 4) C.B. 686.

PLR-122359-03

Section 142(f)(3) provides that no bond may be issued as part of an issue with respect to a facility for the local furnishing of electric energy or gas unless -

(A) the facility will –

(i) be used by a person who is engaged in the local furnishing of that energy source on January 1, 1997; and

(ii) be used to provide services within the area served by such person on January 1, 1997 (or within a county or city any portion of which is within such area), or

(B) the facility will be used by a successor in interest to such person for the same use and within the same service area as described in subparagraph (A).

Section 142(f)(3) was added by § 1608(a) of the Small Business Job Protection Act of 1996 (the “1996 Act”), 1996-3 C.B. 155, 240. The version of the 1996 Act passed by the House of Representatives did not contain a provision relating to § 142(f). The Senate Report contains the following explanation of the successor in interest concept in § 142(f)(3)(B):

To facilitate compliance with electric and gas industry restructuring now in progress, the provision further permits continued qualification of successor entities under a “step-in-the shoes” rule without regard to common ownership if the service provided remains unchanged and the area served after the facilities are transferred does not exceed the area served before the transfer. For example, if facilities of a person engaged in local furnishing are sold to another person, the purchaser (when it engages in otherwise qualified local furnishing activities) is eligible for continued tax-exempt financing to the same extent that the seller would have been had the sale not occurred if the service provided and the area served do not change.

S. Rep. No. 104-281, at 118 (1996).

The Conference Report further provides as follows:

The conferees also wish to clarify several questions that have arisen since the passage of the Senate amendment with respect to the limitation on future eligibility under the local furnishing exception. First, because the conference agreement precludes issuance of tax-exempt bonds except for local furnishers engaged in that activity on January 1, 1997 (and successors in interest), the statutory wording of the provision differs from the traditional focus of the local furnishing exception on a two county (or city and contiguous county) area without regard to the entity providing the service. The statutory references to “persons” engaged in local furnishing of electricity or gas contained in the conference

agreement are intended to prevent new entities (other than successors in interest) from qualifying for tax-exempt financing under the local furnishing exception. They are not to be construed in a manner affecting the tax-exempt status of interest on any outstanding bonds or the receipt of additional tax-exempt financing by an existing local furnisher, provided that the facilities financed with those bonds are used at all times in qualified local furnishing activities (defined under present law as modified by the conference agreement) and the bonds comply otherwise with the Internal Revenue Code's requirements for tax-exemption.

H.R. Conf. Rep. No. 104-737, at 1045 (1996), 1986-3 C.B. 741, 1045-1046.

The Conference Committee Report contains two examples which provide some insight into what is meant by the term "successor in interest" for purposes of § 142(f)(3) of the Code. In Example 1, an existing local furnishing utility, as part of a reorganization, sells a portion of its service area to a third party. The report explains that the retained portion of the utility's service territory continues to qualify for tax-exempt financing under the local furnishing exception provided no violations of that exception occur (such as an impermissible interconnection with facilities outside the area). The example in the report explains that the determination of whether the portion of the service territory that is sold to a third party continues to qualify depends on the manner in which the purchaser provides service in the area it acquires. The report states that if "the purchaser operates in the area which it purchases in a manner that otherwise qualifies under the local furnishing exception, the purchaser is treated as a successor in interest to the seller and facilities for the area that is sold continue to be treated as used in local furnishing." H.R. Conf. Rep. No. 104-737 at 1046 (1996), 1986-3 C.B. 741, 1046.

In Example 5 of the Conference Report, a local furnishing utility decided to contract with a newly-formed independent power generating venture to construct a generating plant that will sell electricity to it exclusively for use in its service area. The report concludes that tax-exempt bonds may not be issued under the local furnishing exception for construction of the generating plant since "the independent power producer was neither engaged in the local furnishing of electricity to the service area involved on the effective date of the conference agreement's restriction nor is it a successor in interest under the agreement." H.R. Conf. Rep. No. 104-737 at 1045, 1986-3 C.B. 741, 1045-1047.

In this case, S1 is a "successor in interest" to Electric Company within the meaning of § 142(f)(3)(B). First, Electric Company was a local furnishing utility that operated its Local Electric System and provided electric energy using the Transferred Generating Assets to its Customers in the Service Area on January 1, 1997. Electric Company received two private letter rulings that its facilities at the time were facilities for the local furnishing of electric energy within section 142(a)(8) and in one of the

PLR-122359-03

rulings, Electric Company's local system was found to be a system providing service to the general populace of the geographical service area as required under § 142(f)(1). These activities continued on Date 3, the date of restructuring. Second, Electric Company transferred the electric generating assets to Holding Company and S1 received the Transferred Generating Assets from the Holding Company. Third, S1 will use the Transferred Generating Assets in the same qualified local furnishing activity as Electric Company because the area served by the Transferred Generating Assets will be the same as the Service Area served by Electric Company on January 1, 1997. S1 will sell all of the output from the Transferred Generating Assets to Authority and New Electric Company under the Power Supply Agreement and Authority and New Electric Company will provide electric service only to the Customers in the Service Area. Fourth, the restructuring resulted in Electric Company's pre-transaction shareholders owning a percent of the Holding Company. Accordingly, S1 is a successor in interest to Electric Company for purposes of § 142(f)(3)(B).

Service to the General Public

S2 is required under the Power Purchase Agreement to sell all of the output generated from the Facilities to New Electric Company and Authority; and both Authority and New Electric Company are required to serve only the Customers in the Service Area. Moreover, S1 as the owner and operator of the Facilities is obligated under the Power Supply Agreement to supply Authority and New Electric Company with electricity from the Transferred Generating Assets formerly owned by Electric Company for service to the Customers in the Service Area. Since the Power Supply Agreement was subject to the approval of the Commission and FERC and S1's obligation to provide electricity is subject to ongoing oversight by FERC, the agreement is the equivalent of the legislative or regulatory obligation described in § 1.103-8(f)(1)(ii). Accordingly, the Facilities will serve or be available on a regular basis for general public use within the meaning of § 1.103-8(a)(2) and § 1.103-8(f)(1).

Conclusions:

Based upon the facts and representations set forth above, we conclude that S1 is a successor in interest to Electric Company for purposes of § 142(f)(3)(B) of the Code and the Facilities will serve or be available on a regular basis for general public use within the meaning of § 1.103-8(a)(2) and § 1.103-8(f)(1). No opinion is expressed concerning whether the interest on the Bonds to be issued by the Issuer will be exempt from tax under § 103.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

PLR-122359-03

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)

By: _____
Timothy L. Jones
Senior Counsel, Tax Exempt Bond Branch

cc: