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In Re:

Date:
October 20, 2021

LEGEND:

Taxpayer =

Parent =

Partnership =

State A =

State B =

Commission A =

Commission B =

RTO =

LLC1 =

LLC2 =

ProjectCo =

Facility =

Dear :

This letter responds to your request dated April, 20, 2021, for a ruling regarding the application of § 168(i)(10) and the normalization rules of § 168 and former § 46(f) of the Internal Revenue Code with regards to the facts described below.

FACTS:

Taxpayer is a utility located and incorporated in State A. Taxpayer is wholly owned by Parent. Taxpayer is included in Parent's consolidated tax return, filed on a calendar year basis. Taxpayer uses the accrual method of accounting. Parent is incorporated in State B.

Taxpayer is an integrated utility that is primarily engaged in generating, transmitting, distributing and selling electric energy to retail customers in State A. Taxpayer is subject to the jurisdiction of Commission A and Commission B. Taxpayer is one of many transmission system owner-members in RTO, a regional transmission organization. RTO operates on a merit order dispatch, considering transmission constraints and other reliability issues to meet the total demand in the RTO region. Taxpayer offers electricity in the RTO day-ahead and real-time markets.

Taxpayer created LLC1, a wholly-owned limited liability company treated as a corporation for federal income tax purposes, with a capital contribution of cash. LLC1 and an unrelated power generation development company (Developer) executed a membership interest purchase, project development, and construction management agreement to acquire ProjectCo, the owner of Facility, a solar electric production facility currently being developed. The Facility is expected to qualify for the Investment Tax Credit (ITC).

Upon obtaining Commission A approval, LLC1 will acquire all of ProjectCo from Developer. After acquisition, ProjectCo will be a disregarded entity for tax purposes and treated as part of Taxpayer. Taxpayer will then create a subsidiary and join with that subsidiary to form LLC2. LLC2 will join with one or more unrelated parties (Partner) to form Partnership. Partnership will be treated as a partnership for federal income tax purposes. LLC1 will sell its membership interest in ProjectCo to Partnership. ProjectCo will be disregarded for tax purposes and be treated as a part of Partnership for federal tax purposes. After Partner achieves its targeted after-tax yield (expected to occur seven or eight years after the commercial operations begin), Taxpayer will have the option to buy out Partner's interest in Partnership at a mutually agreed-upon price (fair market value) determined at that time.

Facility will be self-certified as an exempt wholesale generator under guidelines administered by Commission B. Partnership also expects to obtain permission from Commission B for market-based rate authority, that is, the authority to sell Facility's

electricity at market-based wholesale rates, rather than at cost-based rates with a regulated rate of return. Partnership will sell electricity directly to the wholesale electricity markets administered by regional transmission organization (RTO). Partnership will not sell energy to Taxpayer and there will be no power purchase agreement between Partnership and Taxpayer. Rather, Taxpayer will purchase electricity, as needed, on the wholesale markets at prices administered by RTO for its customers.

The economic value of electricity produced by Facility is greater than the mere value of the energy itself since Facility's production of solar energy will also yield renewable energy certificates (REC) and RTO zonal resource credits (ZRC).

Taxpayer will enter into an agreement with Partnership under which Taxpayer will pay to Partnership a fixed price tied to a notional amount of power (corresponding to actual power generated by Facility) and the expected values of the RECs' and the ZRCs' resulting from operation of Facility. The RECs and ZRCs generated by Facility are assigned to Taxpayer under the agreement. In return, Partnership will pay to Taxpayer a market-based amount related to the same amount of power. To the extent the amount of these payments differ, the agreement provides for a net settlement payment to equalize the cash flows between Taxpayer and Partnership. The net settlement payment (if any) is not determined by or related to, any aspect of cost of service, rate of return ratemaking, but operates as a hedge for both parties against energy price fluctuations, volumetric fluctuations, and other market-related risks.

The facts above are contingent on Taxpayer and Partnership obtaining approval for the various parts of the transaction from Commission A and Commission B.

RULINGS REQUESTED:

1. Whether the Facility owned by Partnership is public utility property under § 168(i)(10) and former § 46(f)(5) and therefore subject to the normalization rules of § 168(i)(9) or former § 46(f)?

2. Whether Taxpayer or Partner are subject to the deferred tax normalization rules of § 168(i)(9) as a result of their investments in Partnership or the transactions between Taxpayer and Partnership?

3. Whether Taxpayer or Partner are subject to the ITC tax normalization rules of former § 46(f) as a result of their investments in Partnership or the transactions between Taxpayer and Partnership?

LAW AND ANALYSIS:

Section 168(f)(2) provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

Section 168(i)(10) defines, in part, public utility property as property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, have been established or approved by a state or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any state or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, § 168(i)(10) defined public utility property by means of a cross reference to § 167(l)(3)(A). Section 167(l)(3)(A) as then in effect contained the same definition of public utility property that is currently in § 168(i)(10). Section 1.167(l)-1(b) provides that under § 167(l)(3)(A), property is public utility property during any period in which it is used predominantly in a § 167(l) public utility activity. The term “section 167(l) public utility activity” means, in part, the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in § 167(l)(3)(A). The term “regulatory body described in section 167(l)(3)(A)” means a state (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any state or political subdivision thereof similar to such a commission. The term “established or approved” includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, even though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

The definitions of public utility property contained in § 168(i)(10) and former § 46(f)(5) are essentially the same. Pursuant to § 50(d)(2), rules similar to the rules of former § 46(f), as in effect on November 5, 1990, continue to determine whether an asset is public utility property for purposes of the investment tax credit normalization rules. As in effect at that time, former § 46(f)(5) defined public utility property by reference to former § 46(c)(3)(B).

The regulations under former § 46 (of continuing applicability by virtue of § 50(d)(2)) contain an expanded definition of regulated rates in § 1.46-3(g)(2)(iii). This expanded definition embodies the notion of rates established or approved on a rate-of-return basis, where rate of return includes a fair return on the taxpayer’s investment in providing such goods and services. Furthermore, 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. In addition to the definition in the § 46 regulations, there is an expressed reference to rate of return in § 1.167(l)-1(h)(6)(i).

The operative rules for normalizing timing differences relating to use of different methods and periods of depreciation are only logical in the context of rate-of-return regulation. The normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under § 168, is defined in terms of the method the taxpayer uses in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account. Therefore, for purposes of the application of the normalization rules, the definition of public utility property is the same for purposes of the investment tax credit and depreciation.

Thus, under both the depreciation and the investment tax credit normalization rule definitions, a facility must meet three requirements to be considered public utility property:

1. It must be used predominantly in the trade or business of the furnishing or sale of, inter alia, electrical energy;

2. The rates for such furnishing or sale must be established or approved by a state or political subdivision thereof, any agency or instrumentality of the United States, or by a public service or public utility commission or similar body of any state or political subdivision thereof; and

3. The rates so established or approved must be determined on a rate-of-return basis.

The Facility will meet the first requirement as it will be used predominantly in the trade or business of the furnishing or sale of electrical energy. The Facility will also meet the second requirement as it will be subject to the jurisdiction of Commission B.

The Facility will not meet the third requirement because Partnership will use the Facility to sell the energy the Facility generates at rates established on a market basis (and not on a rate-of-return or cost basis), under market-based rate authority from Commission B. Nor will the agreement between Taxpayer and Partnership involve the sale of electricity at rates established at a rate-of-return or cost basis. Thus, to the extent power is sold from the Facility under the agreement, the Facility will not be public utility property under § 168(i)(10), and therefore, related depreciation deductions and investment tax credits will not be subject to the normalization rules of § 168 or former § 46(f).

Based on the forgoing we conclude that:

1. Facility owned by Partnership is not public utility property and therefore is not subject to the normalization rules of § 168(i)(9) or former § 46(f).

2. Neither Taxpayer nor Partner are subject to the deferred tax normalization rules of § 168(i)(9) as a result of their investments in Partnership or the related transactions between Taxpayer and Partnership described herein.

3. Neither Taxpayer nor Partner are subject to the ITC tax normalization rules of former § 46(f) as a result of their investments in Partnership or the related transactions between Taxpayer and Partnership described herein.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above-described facts under any other provision of the Code or regulations. Specifically, nothing in this letter should be construed as endorsing that the Partnership will be respected for federal tax purposes. In addition, no opinion is expressed concerning whether Partnership is eligible to elect out of partnership treatment under § 761. Finally, the conclusions reached above are dependent on approvals of various parts of the described transactions by Commission A and Commission B.

This ruling is directed only to the taxpayer requesting it. We note that, while we have concluded that "Partner" is not subject to either the deferred tax or ITC normalization rules under the facts described above, no person may legally rely on a ruling not issued to that person. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements 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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

/s/
Patrick S. Kirwan
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

cc: