Internal Revenue Service

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Re:

Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

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Date:
June 30, 2022

LEGEND:

Taxpayer =

Parent =
Company A =
Company B =
Company C =
Company D =
Company G =
Utility DevCo =
Utility Sub =
Utility Sponsor =
ProjectCo =
Partnership =
Facility =
Country A =
Fund A =
a =
b =
c =
d =
e =
f =
g =
h =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Year A =

City A =
State A =
State B =
County =
City B =
Commission A =
Commission B =
Case =
RTO =
System =

Dear :

This letter responds to your letter, dated December 17, 2021, requesting a ruling on the application of the depreciation normalization requirements with respect to the computation of accumulated deferred income taxes in its calculation of rate base.

FACTS

Taxpayer is a State A corporation files a consolidated federal income tax return on a calendar year basis with its affiliates, including its Parent, a State B Corporation. All of the common stock of Taxpayer is owned by Company A. The stock of Company A is owned a% by Company B and b% by Fund A, an otherwise unrelated party and wholly-owned subsidiary of Company C a Country A company. The stock of Company B is owned c% by Company D and d% by Company C. Company D is wholly-owned by Parent.

Taxpayer is an integrated utility that is engaged primarily in generating, transmitting, distributing and selling electric energy to retail customers in City A and neighboring areas within State A and is subject to regulatory authority of Commission A and Commission B.

Taxpayer formed Utility DevCo, a wholly-owned disregarded entity for federal income tax purposes, with a contribution of cash. Utility DevCo entered into a membership interest purchase and project development agreement providing for the acquisition of ProjectCo on Date 1 for $e. ProjectCo, a limited liability company, is a wholly-owned subsidiary of Company G and is developing Facility. Facility is a f-megawatt solar project with a g MWh DC battery energy storage system (BESS) located in County of State A.

On Date 2, Taxpayer filed with Commission A an application for a certificate of authority to acquire, construct, own, and operate Facility and an application for approval of affiliated interest agreements related to ownership and operation of Facility. The Facility is expected to be placed in service in Year A. Taxpayer also expects that the Facility will qualify for the investment tax credit.

Taxpayer will form Utility Sub, a corporation for federal income tax purposes, with a capital contribution of cash. Utility Sub and Taxpayer will create Utility Sponsor, a partnership for federal income tax purposes, with capital contributions. Utility Sponsor

will form Partnership, a partnership for federal income tax purposes, with one or more unrelated unnamed partners with capital contributions of cash pursuant to an equity capital contribution agreement.

Utility DevCo will sell all of the membership interests of ProjectCo to Partnership prior to the date that the Facility is placed in service. ProjectCo will be disregarded for federal income tax purposes. Partnership will execute a limited liability company operating agreement (LLCOA) that will allocate cash and property distributions; profits, losses, and tax credits; and other rights/responsibilities between Utility Sponsor and one or more investor-partners (referred to herein as “Partner”).

ProjectCo will file for and is expected to receive market-based rate authority from Commission B allowing it to make any sales of electricity, capacity, and ancillary services at market-based rates into the wholesale market, rather than at cost-based rates with a regulated rate of return. From the date of commercial operations, ProjectCo will sell the electricity produced by Facility directly to the wholesale electricity markets administered by RTO. ProjectCo will not sell energy to Taxpayer and there will not be a power purchase agreement between ProjectCo and Taxpayer.

Taxpayer will acquire electricity from the wholesale electricity markets at market prices as administered by RTO. The timing and volumes of purchased power will be determined based on demand for power by Taxpayer’s customers in the normal course of business operations and without regard to the timing and volumes of power sold by ProjectCo. Such transactions to serve customer load will occur at market prices as administered by RTO.

Taxpayer and ProjectCo will enter into a capacity agreement and contract for differences agreement with a term of h years. Under this contract, Taxpayer will pay ProjectCo a fixed price related to a notional amount of power, the operating capacity of the BESS, as tested, and an efficiency rate factor based on the minimum guaranteed efficiency rate for the BESS and actual efficiency, and the expected value of renewable energy certificates (RECs) and RTO zonal resource credits (ZRCs) resulting from operation of the Facility. The notional amount of power will correspond to the actual volume power generated by the Facility. In return, ProjectCo will pay Taxpayer a market-based amount related to the same amount of power and provide the RECs and ZRCs from the operation of the Facility. The market-based amount is expected to be based on the RTO-settled price for electricity at point of generator interconnection near City B. The portion of the contract not related to RECs or ZRCs will be financially settled and not allow for settlements with physical delivery of power. Such amounts will be netted into a single monthly settlement to be paid (or received) by Taxpayer to (or from) ProjectCo. ProjectCo will secure Commission B approval to enter into this contract, and Taxpayer will secure Commission A approval to enter into this contract. As described above, Taxpayer represents that the net settlement terms of this contract are not based on cost-of-service, rate-of-return ratemaking.

RECs are a means to track progress towards and compliance the renewable portfolio standards (RPS) of a particular jurisdiction. State A does not have an RPS and Taxpayer is not currently subject to an RPS. However, any corporation, business, nonprofit or individual may purchase RECs to meet their renewable energy objectives. Taxpayer expects that the RECs resulting from generation of solar energy by the Facility will be tracked through the System or a similar system. The ownership of RECs created by the Facility are assigned to Taxpayer via the contract described above. Taxpayer may either retain the RECs associated with the Facility or sell them. Taxpayer intends to retire RECs associated with the Facility.

The contract also assigns the RTO ZRCs from the Facility to Taxpayer. RTO requires member load-serving entities (LSEs) such as Taxpayer to maintain sufficient electric capacity rights such that the LSE can reasonably be expected to deliver electricity to meet customer demand. The RTO capacity obligation of an LSE for a given RTO capacity year (i.e., June through May) is based on forecasted peak demand plus a planning reserve margin. An LSE may satisfy its RTO capacity obligation with power generation facilities that it owns or by acquiring additional capacity through bilateral transactions with other market participants or by bidding on capacity in RTO's annual planning resource auction. For any given RTO capacity year (June-May), if a LSE has more than enough capacity resources to cover its forecasted peak demand and planning reserve margin, the LSE may sell its excess capacity through bilateral transactions with other market participants or may offer capacity in RTO's planning resource auction. Market participants utilize RTO ZRCs to transact in RTO capacity rights. To the extent that actual annual net capacity revenues (or expenses) vary from the amounts reflected in Taxpayer's basic rates and charges for service, such variance is returned to (or recovered from) customers through an adjustment to retail rates in Taxpayer's existing capacity adjustment mechanism (rider), resulting in a credit or surcharge to Taxpayer's retail customers after an annual reconciliation regulatory proceeding.

Commission B has jurisdiction with respect to the RTO capacity market. Such regulation does not involve cost-of-service, rate-of-return regulation. RTO ZRCs created by a generation facility may be transferred separately from the energy generated by the power plant. The RTO ZRCs resulting from operation of the Facility will be transferred as a separate transaction from the energy. Specifically, the contract directly assigns the ownership of RTO ZRCs attributable to the Facility to Taxpayer. Partnership intends to treat RTO ZRCs resulting from operation of the Facility as self-created intangibles for federal income tax purposes and to apply Treas. Reg. Sec. 1.263(a)-4 to such RTO ZRCs.

As part of the proceedings with Commission A, Taxpayer is requesting that it be able to include the unrecovered cost of its investment in Partnership in rate base and that it be able to recover the cost of its investment in Partnership ratably over the expected life of the investment in Partnership.

ProjectCo filed a petition with Commission A on Date 3, requesting Commission A to enter an order declining to exercise its jurisdiction over ProjectCo's construction, ownership, and operation of the Facility. On Date 4, parties in ProjectCo State A proceeding submitted a proposed order to Commission A.

On Date 5, Commission A issued a final order for Case. The final order resulted in the approval of the proposed ratemaking (except as described in the next sentence) and in Commission A declining to exercise authority over ProjectCo or Partnership. Commission A approved Taxpayer's estimated cost of the Facility and established a cap on cost recovery and associated 50/50 sharing with respect to costs in excess of the approved amount, subject to the ability of Taxpayer to seek approval additional cost recovery in limited circumstances (i.e., due to force majeure, unforeseeable conditions at the site, supply chain disruptions that impact the import of foreign-sourced materials and changes in law or regulation).

RULINGS REQUESTED

1. The Facility owned by Partnership will not be public utility property under § 168(i)(10) and former § 46(f)(5) and, thus, Partnership will not be subject to the deferred tax normalization rules of § 168(i)(9) or the ITC normalization rules of former § 46(f) with respect to the Facility.

2. The Facility will not be treated as public utility property owned by Taxpayer or Partner and, thus, neither Taxpayer nor Partner will be subject to the deferred tax normalization rules of § 168(i)(9) with respect to the Facility.

3. The ITC with respect to the Facility will not be subject to the ITC normalization rules of former § 46(f) by Taxpayer or Partner.

4. Partnership will not be engaged in an automatically excepted regulated utility trade or business under Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(A) but will be eligible to make an election under Treas. Reg. Sec. 1.163(j)-1(b)(15)(iii)(C) to treat its trade or business as an electing regulated utility trade or business under Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(B). Making such election would have no effect on the application of the deferred tax normalization rules of § 168(i)(9), the ITC normalization rules of former § 46(f) or any of the first three conclusions of this ruling.

LAW AND ANALYSIS

First Ruling

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 § 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, though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by Taxpayer.

The definitions of public utility property contained in § 168(i)(10) and former § 46(f)(5) are essentially identical. 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)), specifically § 1.46-3(g)(2)(iii), contains an expanded definition of regulated rates. 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 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 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.

Facility will be used by Partnership predominantly in the trade or business of the furnishing or sale of electric energy. Therefore, Facility will meet the first requirement. In addition, the sales of electricity by Partnership will be under the jurisdiction of Commission B. Therefore, Facility will also meet the second requirement.

However, as described above, the rates for the sale of electricity produced by Facility and sold to RTO are determined under the market-based rate authority of Commission B and not on a cost-of-service or rate-of-return basis. Accordingly, the Facility does not meet the third requirement and we thus conclude that the Facility owned by Partnership will not be public utility property within the meaning of § 168(i)(10) and former § 46(f)(5).

Second and Third Ruling

Section 1.167(l)-3(c) provides, in relevant part, that if property held by a partnership is not public utility property in the hands of the partnership but would be public utility property if an election were made under § 761 to be excluded from partnership treatment, then § 167(l) shall be applied by treating the partners as directly owning the property in proportion to their partnership interests. Therefore, § 1.167(l)-3(c) first considers whether such property is public utility property at the partnership level. If not, it then considers whether such property would be public utility property at the partner level, but only if the partnership is of a type that the partners are eligible to elect out of partnership treatment under § 761.

As discussed above with respect to the first ruling request, Facility is not considered public utility property in the hands of the Partnership. In addition, Taxpayer represents that Taxpayer and Partner are ineligible under § 761 to elect out of partnership treatment. The inability of Taxpayer and Partner to make such an election removes Facility from possible § 1.167(l)-3(c) consideration in the hands of Partner and Taxpayer. Accordingly, based solely on Taxpayer's representations, we conclude that Facility is not treated as public utility property owned by Taxpayer or Partner under § 168(i)(10) or § 1.167(l)-3(c).

Therefore, the ITC with respect to the Facility will not be subject to the ITC normalization rules of former § 46(f) by Taxpayer or Partner.

Fourth Ruling

Section 163(j)(1) limits the amount allowed as a deduction for any taxable year for business interest expense interest paid or accrued on indebtedness properly allocable to a trade or business.

Section 163(j)(7)(A)(iv) provides that, for purposes of defining a trade or business under § 163(j), the term "trade or business" does not include the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services; gas or steam through a local distribution system; or transportation of gas or steam by pipeline, 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, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

Treas. Reg. Sec. 1.163(j)-1(b)(15)(i) defines the term "excepted regulated utility trade or business" as one of three trades or businesses: a trade or business as defined in Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(A) (an "automatically excepted regulated utility trade or business"); a trade or business as defined in Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(B) (an "electing regulated utility trade or business"); or a trade or business as

defined in Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(C) (a “designated excepted regulated utility trade or business”).

Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(A) defines an “automatically excepted regulated utility trade or business” as a trade or business that furnishes or sells, electrical energy, water, or sewage disposal services; gas or steam through a local distribution system; or transportation of gas or steam by pipeline, but only to the extent that the rates for the furnishing or sale of such items, 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 and are determined on a cost of service and rate of return basis; or have been established or approved by the governing or ratemaking body of an electric cooperative.

Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(B) defines an “electing regulated utility trade or business” is defined as a trade or business that makes a valid election under Treas. Reg. Sec. 1.163(j)-1(b)(15)(iii).

Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(C) defines a “designated excepted regulated utility trade or business” as a trade or business that that is specifically designated by the Secretary in guidance published in the Federal Register or the Internal Revenue Bulletin as an excepted regulated utility trade or business.

Treas. Reg. Sec. 1.163(j)-1(b)(15)(iii) provides that a trade or business that is not an automatically excepted regulated utility trade or business or a designated excepted regulated utility trade or business and that furnishes or sells items described in Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(A)(1) (i.e., electrical energy, water, or sewage disposal services; gas or steam through a local distribution system; or transportation of gas or steam by pipeline) is eligible to make an irrevocable election to be an excepted regulated utility trade or business to the extent that the rates for furnishing or selling such items have been established or approved by a regulatory body described in Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(A)(2)(i).

As described above, Partnership will set the rates it charges RTO for electricity to be produced by Facility under the market-based rate authority of Commission B (not on a cost-of-service or rate-of-return basis). Accordingly, we conclude that Partnership is not an automatically excepted regulated utility trade or business under Treas. Reg. Sec. 1.163(j)-1(b)(15)(i)(A).

Partnership will predominantly use Facility in the trade or business of the furnishing or sale of electric energy. In addition, Partnership will be under the jurisdiction of Commission B. Therefore, Partnership is eligible to make an irrevocable election to be an excepted regulated utility trade or business under Treas. Reg. Sec. 1.163(j)-1(b)(15)(iii).

In the preamble to the final § 163(j) regulations, it states that:

> The rules set forth in the final regulations are limited solely to the determination of an 'excepted regulated utility trade or business' for purposes of section 163(j)(7)(A)(iv). As a result of this limited application, the rules in the final regulations are not applicable to the determination of 'public utility property' or the application of the normalization rules within the meaning of section 46(f), as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990, section 168(i)(9) and (10) and the regulations thereunder, or to the determination of any depreciation allowance available under sections 167 and 168.

T.D. 9905, 85 Fed. Reg. 56686, 56696 (Sep. 14, 2020). Accordingly, making such election would have no effect on the application of the deferred tax normalization rules of § 168(i)(9), the ITC normalization rules of former § 46(f) or any of the first three conclusions of this ruling.

Except as explicitly determined above, no opinion is expressed or implied concerning the federal income tax consequences of the matters described above under any other provisions of the Code (including other subsections of § 168). Specifically, Taxpayer has not requested a ruling regarding whether the Partnerships will be respected as partnerships for federal income purposes nor provided partnership agreements for Partnerships. Accordingly, nothing in this letter should be construed as providing a ruling or other determination that the Partnerships will be respected as partnerships or that any purported owner will be respected as a partner for federal income tax purposes. In addition, 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

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. This ruling is based upon information and representations submitted on behalf of 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 a ruling, it is subject to verification on examination.

This letter is being issued electronically in accordance with Rev. Proc. 2020-29, 2020-21 I.R.B. 859. A paper copy will not be mailed to Taxpayer.

Sincerely,

Patrick S. Kirwan
Branch Chief, Branch 6
(Passthroughs & Special Industries)

cc: