

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201131010**
Release Date: 8/5/2011

Third Party Communication: None
Date of Communication: Not Applicable

Index Number: 168.20-00

Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B07
PLR-145348-10

Date:
May 03, 2011

Re: Request for Private Letter Ruling under Section 168(e)

Legend:

- Taxpayer =
- Company 1 =
- Company 2 =
- State 1 =
- State 2 =
- City =
- Ballpark =
- Building =
- Date 1 =
- Date 2 =
- Year 1 =
- Year 2 =
- Year 3 =
- a =
- b =
- c =
- d =
- e =
- f =
- g =
- h =
- i =
- i =

k =
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o =

Dear :

This letter responds to a letter dated October 25, 2010, and subsequent correspondence, submitted on behalf of Taxpayer, requesting a letter ruling that certain of Taxpayer’s tangible depreciable property used in its business activity is 7-year property described in section 168(e)(3)(C)(v) of the Internal Revenue Code.

FACTS

Taxpayer is primarily engaged in the ownership and operation of power generation facilities, purchasing fuel and transportation services to support its power plant operations, and marketing and trading energy, capacity, and related products. Taxpayer is a corporation that is the parent of a consolidated group for federal income tax purposes. Taxpayer uses an annual accounting period ending December 31 and the overall accrual method of accounting for maintaining its accounting books and records and filing its federal income tax return.

On Date 1, Taxpayer purchased the ownership interest of Company 1, a single-member limited liability company registered in State 1 and headquartered in City. Company 1 is a disregarded entity for federal income tax purposes and is wholly-owned by Company 2. Company 2 is also a disregarded entity for federal income tax purposes and is wholly-owned by Taxpayer. By acquiring the ownership interest in Company 1, Taxpayer acquired ownership for federal income tax purposes of all of the assets of Company 1. Taxpayer will continue to run the purchased business of Company 1 under the same name.

Company 1 is an operator of district energy systems in State 2. Company 1 builds, owns, operates, and maintains systems that provide cooling, heat, and electricity to end-use customers such as office and municipal buildings, residential buildings, hotels, university campus facilities, and entertainment venues.

In general, district heating and cooling systems produce steam, hot water, or chilled water at a central plant and then pipe that energy out through a municipal “loop” to buildings in the district for space heating, domestic hot-water heating, and air

conditioning. Individual buildings that take advantage of a district heating and cooling provider do not need their own boilers or furnaces, chillers, or cooling towers.

The assets of a district cooling system consist of a central chilled-water plant, a chilled-water supply line (usually underground), off-take points to individual buildings, and a return line to bring the water back to the central plant. The assets in the plant include chillers, cooling towers, thermal storage galvanized steel coils, pumps and motors, electrical systems, chemical systems, plant wiring, plant piping, and control systems. Central chilled-water plants typically run on electricity, steam-turbine drives, or steam absorption.

Taxpayer is requesting a letter ruling solely with respect to Taxpayer's (formerly Company 1's) district cooling system in downtown City, which supplies cooling to multiple customers.

Taxpayer's district cooling system in downtown City uses three chiller plants, Plants 1, 2, and 3, to feed the system's a miles of chilled water pipeline, which circulates b million gallons of water at 34°F throughout downtown City. This system is a closed loop, in that the chilled water never leaves the pipe, but the "loop" runs from the plant to the extremities of the supply lines and then returns to the plant through a set of two parallel pipes (rather than as a circle), so the system's actual length is about c miles.

The pipeline is generally laid underground, in trenches, below the city's streets, and the extensions to a customer's building connect to the customer's basement. Along the pipe, in the same below-ground trench, are wires (like fiber-optic cable) that extend from the plant to the meters at each customer's location, which record the customer's use for billing purposes and enable Taxpayer to monitor the use of its district cooling system in downtown City.

Plant 1 and Plant 3 are located across the street from each other, and Plant 2 is about two blocks away. There is no connection between Plant 1 and Plant 3, or between either of them and Plant 2, except through the closed loop pipeline. Each plant has separate connections to the closed loop pipeline.

Plant 1 includes one building with minor structures and an adjacent ice thermal facility. Plant 1 was built in Year 2 and is used as the main chilled-water generating facility. It also includes a small office area where computer equipment is installed to monitor all of the systems at Plants 1 through 3. Plant 3 is the chiller located in the Ballpark. Together, Plants 1 and 3 supply d tons of cooling to downtown City (e tons to the Ballpark).

At the time Company 1 began operations in Year 2, the Ballpark had been operating its own internal chiller and cooling system, serving only the Ballpark since

Year 1 when it was constructed. The Ballpark chiller pumped chilled water through pipes in the infrastructure of the Ballpark, and large fans blew cooled air from around the pipes into the interior areas of the Ballpark.

Because the Ballpark system was not as efficient as Company 1's chilled water system, the owners of the Ballpark and Company 1 entered into an agreement in Year 2 pertaining to the chiller at the Ballpark, which is still in effect between Taxpayer and the Ballpark. The agreement is a single contract to provide chilled water to the Ballpark, on commercial terms similar to Taxpayer's other customers, but it also gave Company 1 the right to use the chilling equipment that was already located in the Ballpark as part of Company 1's (now Taxpayer's) district cooling system in downtown City. Taxpayer does not have any ownership in the Ballpark chilling equipment and does not depreciate it. Although, Taxpayer would depreciate any improvements it makes to such equipment.

Under the agreement, Company 1 converted the chiller at the Ballpark from being connected directly into the cooling system at the Ballpark, to instead, running chilled water into Company 1's closed loop pipeline that serves all of Company 1's customers. The Ballpark chiller is designated as Taxpayer's Plant 3. Taxpayer is not obligated to use the Ballpark chilling equipment. Whether the Ballpark chiller is operated depends on the overall demand of Taxpayer's customers, not the specific demands of the Ballpark.

To provide chilled water to the Ballpark under the agreement entered into in Year 2, Company 1 constructed a link off of its closed loop pipeline, distinct from the pipes that connect the Ballpark chiller to the pipeline. Whether or not the Ballpark chiller is in operation, Taxpayer has a contractual duty to provide chilled water to the Ballpark. Taxpayer's capacity to provide chilled water to the Ballpark often is satisfied by operating Plants 1 and 2 without operating the Ballpark chiller (Plant 3).

Unlike its other customer connections from the closed loop pipeline, there is no heat exchanger at the Ballpark. Taxpayer's chilled water runs directly from the closed loop pipeline into the cooling system in the Ballpark's infrastructure. As was the case before the Ballpark contracted in Year 2 for Company 1 to provide chilled water, large fans blow the cooled air around the water pipeline into the interior areas of the Ballpark. Taxpayer does not maintain the Ballpark cooling system. Taxpayer's responsibility stops at the point where secondary pumps inside the Ballpark (owned and managed by the Ballpark) control their water flow into the stadium.

In Year 3, Company 1 and the Building, then under construction, entered into separate agreements to lease space for a chilling plant and to provide cooling services to the Building. The lease agreement is for a f-year term, with g options that Taxpayer

can exercise, each for a h-year renewal of the lease. The cooling services agreement is for a single f-year term, with no renewal options.

Under the lease agreement, Company 1 installed its third downtown plant, Plant 2, inside the Building. There is also a cooling tower located on the roof of the Building. As with the Ballpark chiller at Plant 3, the Building chillers are connected to Taxpayer's closed loop pipeline through one set of pipes, and a separate set of pipes delivers chilled water from the closed loop pipeline into the Building. Taxpayer's chilled water is fed into i heat exchangers, which transmit cooling into the Building's system. Taxpayer does not maintain the Building's air conditioning system.

Taxpayer's obligation to provide chilled water to the heat exchangers at the Building is separate from its operation of Plant 2 located in the Building. Taxpayer can provide chilled water into the Building through its closed loop pipeline even if Plant 2 is not in operation. Taxpayer can use Plant 2 in the Building even if Taxpayer is not providing cooling services to the Building. Plant 2 can supply up to j tons of chilled water to Taxpayer's district cooling system in downtown City, and the Building's demand capacity is only k tons. Company 1 installed i l ton chillers in Plant 2 in Date 2, to increase capacity to serve its growing customer base. Taxpayer's options to renew the lease for Plant 2 can be exercised even if there is no new agreement for Taxpayer to provide cooling services to the Building.

A total of m chillers and n thermal storage tanks are employed in downtown City. Each night, chillers pump a 17°F glycol and water mixture through galvanized steel coils in the chilled water storage tank. This produces j million pounds of ice, produced when utility loads and market prices are lowest. During peak cooling periods during the day, the ice is melted, and the water pumped through an underground distribution network to air-condition the buildings. Using the ice reduces the amount of chillers that are required to run during the day, which also reduces electrical peak demand.

A building owner links its building's internal heating, ventilation, and air-conditioning ("HVAC") system to Taxpayer's chilled-water closed loop pipeline through a heat exchanger substation. At the heat exchanger substation, the cold water is run through heat exchangers in which a portion of the cold energy (thermal energy) is transferred from the water to cool the building. The energy transferred from the water is used to cool the buildings in which the substation is located. The heat exchangers are the terminal points of Taxpayer's district cooling system and the point at which the chilled water transfers cooling energy that the customer buys. Taxpayer owns and depreciates the heat exchangers. The customer must connect pipes into the heat exchangers and feed its own water into the exchanger to enable the exchanger to chill the customer's water as it flows through the exchanger in order to provide the cooling the customer will use to operate its central air conditioning system. Taxpayer does not maintain any of its customers' air conditioning systems. Taxpayer can regulate the

amount of chilled water delivered to the heat exchanger in any particular customer's building, as the customer's demands requires. None of the water transmitted through the underground pipes is used by any of the buildings and all of the water is returned to Taxpayer's chiller plants.

After completion of the energy transfer, the now warmer water in Taxpayer's pipe is pumped back and returned to the chiller plants by another underground pipe. The water had a temperature of 34°F when it left the plant, and has a temperature of 50°F to 54°F when it returns. The water upon being return to the chiller plant will be re-chilled in the chiller to complete the water loop and then is re-circulated through the loop.

Taxpayer's customers typically have a long term service agreement with Taxpayer for the use of its district cooling system in downtown City. Most of the agreements are for a 0-year period. There is a monthly charge with a fixed component and a variable component based on the customer's actual use of the system.

Taxpayer's district cooling system is designed to be expanded. In some cases, an older building will be converted from some other cooling system to one that can use a district cooling system. Newer buildings will often be designed and constructed to incorporate a district cooling system from inception. When a new customer is added, an extension will be built from Taxpayer's existing closed loop pipeline to the customer's building.

A customer that stopped using Taxpayer's district cooling system could continue to operate its internal air-conditioning system but would need to find some other source that could cool the water to be circulated through the customer's system. Taxpayer could terminate service to a customer by shutting the pipeline that feeds the heat exchanger with chilled water from the closed loop pipeline.

Taxpayer's district cooling system in downtown City is not "public utility property" within the meaning of section 168(i)(10).

RULING REQUESTED

Taxpayer's tangible depreciable property used in its business activity of circulating chilled water through a closed loop pipeline to customers' premises (other than property having a specifically assigned asset class under Rev. Proc. 87-56 or recovery period), where the water leaves its chiller plant as a cold pressurized liquid, is pumped through underground pipes to various customers' premises, and flows through heat exchangers in which a portion of the cold energy (thermal energy) is transferred from the water to cool the customers' buildings, does not have a class life and, as such, is 7-year property described in section 168(e)(3)(C)(v).

LAW AND ANALYSIS

Section 167(a) provides that there is allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or held for the production of income.

The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168, which prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in section 168(a); and (2) the alternative depreciation system in section 168(g). Under either depreciation system, a taxpayer computes the depreciation deduction by using a prescribed depreciation method, recovery period, and convention.

For purposes of the general depreciation system, the depreciation method, recovery period, and convention are determined by the property's classification under section 168(e). Pursuant to section 168(e)(1), property with a class life of 4 years or less is classified as 3-year property, property with a class life of more than 4 years but less than 10 years is classified as 5-year property, property with a class life of 10 years or more but less than 16 years is classified as 7-year property, property with a class life of 16 years or more but less than 20 years is classified as 10-year property, property with a class life of 20 years or more but less than 25 years is classified as 15-year property, and property with a class life of 25 years or more is classified as 20-year property.

The term "class life" is defined in section 168(i)(1) as meaning the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under section 167(m) (determined without regard to section 167(m)(4) and as if the taxpayer had made an election under section 167(m)) as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990. Former section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range (ADR) system of depreciation, the depreciation allowance was based on the class life prescribed by the Secretary that reasonably reflected the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations provides rules for classifying property under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Section 1.167(b)-11(e)(3)(iii) further provides that in the case of a lessor of property, unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for the property is determined as if the property were owned by the lessee. However, in the case of an asset guideline class based upon the type of

property (for example, trucks or railroad cars) as distinguished from the activity in which used, the property is classified without regard to the activity of the lessee.

The class lives of property subject to depreciation under section 168 are set forth in Rev. Proc. 87-56, 1987-2 C.B. 674. This revenue procedure divides assets into two broad categories: (1) asset classes 00.11 through 00.4 that consist of specific depreciable assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of depreciable assets used in specific business activities. An asset that falls within both an asset group (that is, asset classes 00.11 through 00.4) and an activity group (that is, asset classes 01.1 through 80.0) would be classified in the asset group. See Norwest Corp. & Subs. v. Commissioner, 111 T.C. 105, 156-64 (1998).

If there is not an asset class of Rev. Proc. 87-56 that describes the property or the business activity in which the property is primarily used and if the property is not otherwise classified under section 168(e)(2) or (3), the property is 7-year property pursuant to section 168(e)(3)(C)(v).

The first issue is whether there is an asset class of Rev. Proc. 87-56 that describes Taxpayer's business activity of circulating chilled water through a closed loop pipeline to provide cooling to customers' buildings in downtown City.

Asset classes with the prefix "49" are captioned "Electric, Gas, Water and Steam, Utility Services" and include assets used in the production, transmission, and distribution of electricity, gas, steam, or water for sale including related land improvements. There are two asset classes with the prefix "49" that may apply to Taxpayer's business activity: asset class 49.4, Central Steam Utility Production and Distribution, or asset class 49.3, Water Utilities.

Asset class 49.4 of Rev. Proc. 87-56 includes assets used in the production and distribution of steam for sale. Assets in this class have a class life of 28 years and, as a result, are classified as 20-year property under section 168(e)(1). In this case, the chilled water that is circulated in Taxpayer's district cooling system in downtown City is not changed from a liquid to a vapor (steam). Further, this water is never actually accessed by Taxpayer's customers. Instead, it is the cold energy (thermal energy) transferred through the heat exchanger substation that is furnished by Taxpayer to its customers. Accordingly, Taxpayer's business activity of circulating chilled water through a closed loop pipeline to provide cooling to customers' buildings in downtown City does not produce and distribute steam for sale and, consequently, is not described in asset class 49.4.

Asset class 49.3 of Rev. Proc. 87-56 includes assets used in the gathering, treatment, and commercial distribution of water. Assets in this class have a class life of 50 years and, as a result, are classified as 20-year property under section 168(e)(1). However, section 168(c) assigns a recovery period of 25 years to water utility property,

which is defined in section 168(e)(5) as meaning property that is an integral part of the gathering, treatment, or commercial distribution of water and that, without regard to section 168(e)(5), would be 20-year property.

In this case, none of the water transmitted by Taxpayer through the closed loop underground pipes to buildings for cooling purposes is used by any of Taxpayer's customers and all of the water is returned to Taxpayer's chiller plants. As a result, Taxpayer is not distributing water to its customers. As previously mentioned, Taxpayer is furnishing cold energy (thermal energy) through the heat exchanger substation to provide cooling for its customers' buildings. Further, Taxpayer's district cooling system in downtown City does not gather and treat the water used in that system. Accordingly, Taxpayer's business activity of circulating chilled water through a closed loop pipeline to provide cooling to customers' buildings in downtown City is not described in asset class 49.3.

Because Taxpayer's business activity involves a closed loop pipeline, we also considered asset class 46.0, Pipeline Transportation, of Rev. Proc. 87-56. This asset class includes assets used in the private, commercial, and contract carrying of petroleum, gas, and other products by means of pipe and conveyors. The truck lines and related storage facilities of integrated petroleum and natural gas producers are included in this class. This class excludes initial clearing and grading land improvements as specified in Rev. Rul. 72-403, 1972-2 C.B. 102, but includes all other related land improvements. Assets in this class have a class life of 22 years and, consequently, are classified as 15-year property under section 168(e)(1).

The purpose of Taxpayer's closed loop district cooling system in downtown City is to provide cooling to the buildings of Taxpayer's customers. While the closed loop underground pipes carry the chilled water to each customer's building to provide the cooling, none of the water leaves the pipes. All of the water is returned to Taxpayer's chiller plants. Taxpayer's closed loop district cooling system in downtown City is not supplying water to customers. Consequently, we believe that Taxpayer's business of providing cooling is not an activity of carrying a product by pipe. Thus, Taxpayer's business activity of circulating chilled water through a closed loop pipeline to provide cooling to customers' buildings in downtown City is not described in asset class 46.0.

Accordingly, there is not an asset class of Rev. Proc. 87-56 that describes Taxpayer's business activity of circulating chilled water through a closed loop pipeline to provide cooling to customers' buildings in downtown City.

The second issue is whether the tangible depreciable property Taxpayer uses in its activity of circulating chilled water through a closed loop pipeline to a heat exchanger located in the customers' buildings are structural components.

Section 1.48-1(e)(2) provides that the term “structural components” includes, among other things, all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts.

Taxpayer’s facts involve a district cooling system circulating chilled water in a closed loop pipeline for providing cooling to buildings owned by Taxpayer’s customers. Samis v. Commissioner, 76 T.C. 609 (1981), involves a similar situation where the Court held that despite the separate ownership of a total energy plant (which includes underground pipes for circulating chilled water for air conditioning an apartment complex) and the apartment complex (not owned by the petitioners), the plant must be classified as a structural component of a building. In light of Samis, we will address whether the Samis decision would apply in Taxpayer’s situation to require a conclusion that the tangible depreciable property Taxpayer uses in its activity of circulating chilled water through a closed loop pipeline to a heat exchanger located in the customers’ buildings are structural components.

In Samis, the petitioners were partners in a partnership that owned a total energy plant that served only an apartment complex owned by an unrelated party, KF-IDS. The petitioner’s energy plant supplied hot water, and hot and chilled water for heating and air conditioning, to this apartment complex. Hereinafter, we will refer to the petitioners in Samis as “Petitioners.”

The Court in Samis held that Petitioners’ total energy plant as a whole was a structural component of the KF-IDS apartment buildings, even though the total energy plant was owned by a person separate from the owner of the apartment complex. The Court noted that the definition of “structural components” of a building in section 1.48-1(e)(2) includes “all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts.” The Court found that Petitioners’ total energy plant was an “integral and permanent part” of the central heating and air conditioning system for buildings in the apartment complex. 76 T.C. at 618. The Court stated that “the separate ownership of the energy plant in the present circumstances is wholly irrelevant.” 76 T.C. at 620 n.6. As a result, the Court held that Petitioners’ total energy plant was a structural component of the KF-IDS apartment complex and was not eligible property for which an investment tax credit could be allowed.

In reaching its holding, the Court in Samis found the economic interdependence between Petitioners and the KF-IDS apartment complex very relevant to its determination that Petitioners did not operate as an independent supplier of energy and that their energy plant was an integral and permanent part of the apartment complex. The energy provided by Petitioners could be furnished only to the apartment complex owned by KF-IDS. During the term of the 30-year contract between Petitioners and KF-IDS, KF-IDS had the right to purchase the total energy plant for 10 percent of its original

cost if the contract was not renewed. If Petitioners failed to provide the energy services required by KF-IDS, KF-IDS reserved the right to terminate the contract and succeed to the ownership of the energy plant and distribution system.

Unlike Petitioners' total energy plant in Samis, Taxpayer's district cooling system in downtown City was designed and operated from the beginning to serve numerous customers. Taxpayer's district cooling system has physically expanded along with its customer base and operates independently of any of the building systems operated by its customers.

While the Ballpark and the Building have chillers located within them, these chillers are not dedicated to providing cooling to, respectively, the Ballpark and the Building. Whether the Ballpark chiller (Plant 3) is operated depends on the overall demand of Taxpayer's customers, not the specific demands of the Ballpark. Similarly, Taxpayer can provide chilled water into the Building through its closed loop pipeline even if Plant 2 is not in operation and Taxpayer can use Plant 2 in the Building even if Taxpayer is not providing cooling services to the Building.

Further, each of Taxpayer's customers has a separate contract with Taxpayer to provide cooling. None of these contracts give any of Taxpayer's customers any rights to take over ownership of Taxpayer's district cooling system in downtown City, either upon a breach by Taxpayer during the term of the contract or at the termination of the contract with the particular customer.

Moreover, a customer that stopped using Taxpayer's district cooling system in downtown City could continue to operate its building's central air conditioning system but would need to find some other source that could cool the water to be circulated through the customer's system. The customers that had other cooling systems before they contracted with Taxpayer could begin reusing their earlier cooling systems. Customers also could install equipment that would use a resource other than chilled water for their cooling, such as electric motors that run a cooler.

Based on these factual differences, we believe that Taxpayer's district cooling system in downtown City is not similar to Petitioners' total energy plant in Samis. Accordingly, the tangible depreciable property Taxpayer uses in its activity of circulating chilled water through a closed loop pipeline to a heat exchanger located in the customers' buildings are not structural components.

CONCLUSION

Based solely on the facts and representations and the relevant law and analysis set forth above, we conclude that to the extent that Taxpayer's tangible depreciable property used in its business activity of circulating chilled water through a closed loop pipeline to a heat exchanger located in customers' buildings to cool such buildings is not

described in asset classes 00.11 through 00.4 of Rev. Proc. 87-56, is not classified under § 168(e)(2), and is not otherwise classified under section 168(e)(3), such property used in such business activity does not have a class life and, as such, is 7-year property described in section 168(e)(3)(C)(v).

In accordance with the power of attorney, we are sending copies of this letter to Taxpayer's authorized representatives. We are also sending a copy of this letter to the appropriate operating division director.

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

Sincerely,

Kathleen Reed

KATHLEEN REED
Chief, Branch 7
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2):

Copy of this letter
Copy for section 6110 purposes