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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Refer Reply To:
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Date:
February 13, 2020

In Re:

LEGEND

Parent =

Taxpayer =

Group =

LLC =

Facility =

State =

Commission 1 =

Commission 2 =

Operator =

Agreement 1 =

Agreement 2 =

LLC Agreement =

Date 1 =

Date 2 =

a =

b =

c =

d =

e =

f =

g =

h =

Dear :

This letter responds to your request dated June 10, 2019, for a ruling regarding the application of §§ 168(i)(10) and 707(b) of Internal Revenue Code to the facts described below. The relevant facts as represented in your submission are set forth below.

FACTS

Parent, a State corporation, is the parent company of a group of corporations (Group) that includes members that are regulated natural gas and electric utility companies operating in State. Group files a consolidated federal income tax return on a calendar year basis using accrual methods of accounting. Taxpayer, a State corporation that is wholly owned by Parent, operates primarily as a regulated electric utility in State. Taxpayer is regulated by Commission 1 and is a member of Operator, an organization created in compliance with Commission 2 regulations. Taxpayer is governed by the terms and conditions of Operator's Agreement 1.

As part of its plan to replace a substantial portion of its existing electric generating fleet, Taxpayer intends to invest in and purchase electricity from wind projects. These wind projects are intended to qualify for the production tax credit under § 45. On Date 1, Taxpayer entered into Agreement 2 with an independent third party

(Developer). Pursuant to Agreement 2, Developer will develop a wind energy facility (Facility) and sell it to Taxpayer upon completion. The Facility is expected to be completed before Date 2.

On or before Date 2, Taxpayer and an independent investor (Investor) will enter into a joint venture by forming LLC, a limited liability company treated as a partnership for federal income tax purposes, to purchase and own the Facility. Taxpayer and Investor will each contribute cash to LLC. Investor will contribute approximately a to b percent of the capital of LLC, and Taxpayer will contribute approximately c to d percent. The LLC Agreement will provide that Investor will receive e percent of profits, losses, and production tax credits, and approximately a to b percent of the cash of LLC for the first f years. Taxpayer will receive g percent of the profits, losses, and production tax credits, and the remaining amount of cash. Taxpayer will assign its rights, interests, and obligations under Agreement 2 to LLC, which will purchase the Facility from Developer. LLC will file for and received market-based rate authority from Commission 2, allowing it to make any sales of electricity, capacity, and ancillary services at market-based rates, rather than cost-based rates with a regulated rate of return.

LLC will use the Facility to generate electricity to sell to Taxpayer under a wholesale power purchase agreement (PPA). The PPA is subject to separate approval by Commission 2 because LLC will be an affiliate of Taxpayer. Under the PPA, Taxpayer will purchase all of the electric output and capacity of the Facility. The PPA will have a term of at least h years and will constitute a wholesale PPA under the jurisdiction of Commission 2. Prices under the PPA will be determined on an arm's length, market basis pursuant to market-based rate authority granted by Commission 2 and will not be determined on a rate-of-return basis or cost basis.

Taxpayer will immediately sell all of the electricity purchased from LLC under the PPA into Operator's wholesale electric markets. Concurrently with the sale to Operator, Taxpayer will purchase electricity from Operator's wholesale market to satisfy its obligations to its retail customers. The quantity of electricity it purchases from Operator's markets may differ from the quantity it sells into Operator's markets. The sales to and from the Operator's markets will be at market rates set by Operator, which may differ from each other based on timing and locational differences. As with all PPAs, Taxpayer will pass the cost of electricity directly to its customers without any additional markup through a Commission 1 rate adjustment mechanism.

Taxpayer's sale of electricity to its retail customers is subject to regulation by Commission 1. The LLC structure and related transactions, including the ownership in LLC by Taxpayer and Investor, and the PPA, must be approved by Commission 1. All of the power purchased under the PPA ultimately will be sold to persons that are unrelated to Parent, Taxpayer, LLC, Investor or any of their affiliates.

RULINGS REQUESTED

Taxpayer requests the following rulings:

1. The Facility is not public utility property under § 168(i)(10).

2. Any tax losses of LLC allocated to Investor or Taxpayer resulting from the sale of electricity by LLC to Taxpayer under the PPA will not be disallowed under § 707(b).

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 utility service or public utility commission or other similar body of any State or public 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, 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 or not 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 definition of regulated rates contained in § 1.46-

3(g)(2) adds an additional element to that contained in § 1.167(l)-1(b)(1). Under § 1.46-3(g)(2), a taxpayer's rates are "regulated" if they are established or approved on a rate-of-return basis. Rates regulated on a rate-of-return basis are an authorization to collect revenues that cover the taxpayer's cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services, where the taxpayer's costs and investment are determined by use of a uniform system of accounts prescribed by the regulatory body. There is also 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 predominately in the trade or business of the furnishing or sale of, inter alia, electric 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 predominately in the trade or business of the furnishing or sale of electric energy. The Facility will meet the second requirement as it will be subject to the jurisdiction of Commission 2. The Facility will not meet the third requirement because the electricity it will generate will not be sold at rates determined on a rate-of-return basis. Under the PPA, all of the Facility's electric output and capacity will be sold by LLC to Taxpayer. Taxpayer will sell all of the electricity purchased from LLC under the PPA immediately into Operator's wholesale electric markets. Prices under the PPA will be determined on an arm's length, market basis pursuant to market-based rate authority granted by Commission 2 and will not be determined on a rate-of-return basis or cost basis. Moreover, Commission 1 will not have any jurisdiction over the Facility or LLC, and as a result, cannot influence the rates

Taxpayer will pay for electricity from the Facility. Therefore, we conclude that the Facility is not public utility property under § 168(i)(10).

Regarding the second issue, section 6.09 of Rev. Proc. 2020-1, 2020-1 I.R.B. 1, provides that generally, the Service will not issue a letter ruling or a determination letter if the request presents an issue that cannot be readily resolved before a regulation or any other published guidance is issued. Accordingly, we decline to rule on the second issue based on § 6.09 of Rev. Proc. 2020-1.

Except as specifically 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).

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 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 a ruling, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter ruling is being sent to your authorized representatives. We are also sending a copy of this letter ruling to the appropriate director. A copy of this letter ruling must be attached to any federal income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

David Selig
Senior Counsel, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: