INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

June 08, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 168.18-00
CASE-MIS No.: TAM-118731-06
Number: **200638024**
Release Date: 9/22/2006
Director
Natural Resources and Construction

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference: April 28, 2006

LEGEND:

Taxpayer =
Utility =
Wholesaler =
Plant =
Entity =
X =
Marketer =
Y =
Agreement =
State =
D =
E =

ISSUE(S):

What is the proper asset class for the Plant operated by Taxpayer under Agreement with Marketer?

CONCLUSION(S):

The Plant, owned and operated by Taxpayer, is includable in Asset Class 49.13 of Revenue Procedure 87-56 (1987-2 C.B. 674). Taxpayer operates Plant to generate electricity, and such electricity is available for sale in the wholesale electricity market and to end-users.

FACTS:

Taxpayer is an energy service company that has two primary businesses: Utility, an integrated electric utility, and Wholesaler, a wholesale energy business. Utility owns distribution and transmission lines, and regulated generation facilities, providing electric utility services to commercial and residential customers in State. Wholesaler owns Taxpayer's wholesale energy business, which consists of merchant power facilities that generate electricity and wholesale natural gas pipelines.

Taxpayer owns the Plant, a X megawatt natural gas-fired generating facility located in D. The Plant was sold by Utility to Entity, a disregarded entity owned by Wholesaler. Wholesaler further developed the Plant and repowered it. Wholesaler is wholly owned by Taxpayer and is treated as a disregarded entity for Federal income tax purposes. The Plant has been exempt wholesale generator since E.

The Plant is operated pursuant to Agreement between Entity and Marketer, an independent third party. Under the agreement, the Plant uses natural gas that is owned and provided by Marketer to generate electricity. Entity neither owns nor takes title to the gas used in the Plant, as ownership remains with Marketer. Further, Entity neither owns nor takes title to the electricity produced, as such ownership, immediately upon its generation, vests with Marketer. Marketer sells the electricity to the end-user or another company and pays a fee to a third-party to transport the electricity to the appropriate buyer.

A power purchase agreement exists between Marketer and Utility, which provides that Marketer will provide Utility with Y MW of capacity and up to Y MWHr per hour of firm energy from Plant. The capacity is sold to Utility at predetermined rates; the energy is sold to Utility at market rates. The remaining capacity and associated energy is available for sale by Marketer to other wholesalers and end-users.

LAW AND ANALYSIS:

Section 167 of the Internal Revenue Code provides a depreciation deduction of a reasonable allowance for the exhaustion, wear and tear, or obsolescence of property used in a trade or business or for the production of income. Section 168(a) provides a method for computing depreciation deductions by using, in part, the applicable recovery period. The applicable recovery period, for purposes of either section 168(e)(1) or 168(g)(2), is determined by reference to class life. Section 168(i)(1) provides that the term class life means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under former Code section 167(m) as if it were in effect and the taxpayer were an elector. Prior to its revocation, section 167(m) provided that a depreciation deduction would be computed based on the class life proscribed by the secretary which reasonably reflects the anticipated useful life of the property to the industry or 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). The regulations provide that, to determine the appropriate class life of an asset, the property shall be included in the asset guideline class for the activity in which the property is primarily used, even though the use may be insubstantial in relation to all the taxpayer's activities.

Section 1.167(m) provided that asset classes shall be by industry or other groups. Section 1.167(a)-11(b)(4)(ii) states that asset classes are established in Rev. Proc. 72-10 or its successors. Consistent with section 167(a)-11(b)(4)(iii)(b), which adopts the placing of assets into groups by primary activity of use, Rev. Proc. 72-10 established asset guideline classes based on business activity.

The class lives of property subject to depreciation under section 168 are set forth in Rev. Proc. 87-56. 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 based on broadly defined industry classifications. The activity categories correspond to the industry classification described in the legislative history of section 167(m). An asset that falls within both an asset category (that is, Asset Classes 00.11 through 00.4) and an activity category (that is, Asset Classes 01.1 through 80.0) is classified in the asset category. See Norwest Corp. & Subs. v. Commissioner, 111 T.C. 105, 156-64 (1998). The business activity Asset Class described below is set forth in Rev. Proc. 87-56.

49.13 Electric Utility Steam Production Plant: Includes assets used in the steam power production of electricity for sale, combustion turbines operated in a combined cycle with a conventional steam unit and related land improvements. Also includes package boilers, electric generators and related assets such as electricity and steam distribution systems as used

by a waste reduction and resource recovery plant if the steam or electricity is normally for sale to others.

Taxpayer's position is that the Plant, a merchant power plant and an exempt wholesale generator under the Energy Policy Act of 1992, is properly classified as 7-year property under section 168(e)(3)(C)(v). This section provides that any property which does not have a class life and is not otherwise classified is treated as seven year property. Taxpayer further states the Plant is not properly classified in Asset Class 49.13 (with a 20-year recovery period) because that Asset Class is limited to assets used in the steam production of electricity for sale in businesses where the use, costs and risks involved are those associated with traditional utilities.

Taxpayer states that the section 167 regulations provide that property be classified according to its primary use. Recent court cases have emphasized that this is a use-driven functional standard for assigning asset classifications. See, Duke Energy Natural Gas Corp. v. Commissioner, 172 F.3d 1255 (10th Cir. 1999); Saginaw Bay Pipeline Co. v. U.S., 338 F.3d 600 (6th Cir. 2003); Clajon Gas Co. v. Commissioner, 354 F.3d 786 (8th Cir. 2004). In these three cases, the courts, in interpreting section 1.167(a)-11(b)(4)(iii)(b), determined that the classification of the pipeline companies' assets turned on the functional and contractual relationships surrounding the use of the assets in question, the costs and risks associated with their operation, and the economic character of the taxpayer's gathering activities. In Duke Energy, the 10th Circuit found the gathering systems are literally used by producers for gas production and the literal terms of this description include any gathering system, as long as it is used by a gas producer.

The Plant clearly falls within the literal description of Asset Class 49.13. It uses combustion turbines in a combined cycle with a conventional steam unit to produce electricity. The electric power and energy so generated is delivered to the intergrated electric power transmission grid and is sold to others. The fact that the owner and seller of the electric capacity and energy is different from the owner and operator of the Plant is not relevant to a determination of the functional use of the Plant. The depreciation asset class of the Plant does not turn on the identity of the owner. In the above-referenced pipeline cases, the circuit courts have determined that "differences in ownership does not change how the pipelines are actually used." (Clajon Gas, 354 F.3d at 790; See also Saginaw Bay 338 F.3d at 607). Likewise, the status of Taxpayer being an exempt wholesale generator versus a regulated electric utility does not remove Taxpayer from the purview of Asset Class 49.13. While Activity Category 49 is entitled "Electric, Gas, Water and Steam, Utility Services," the category does not define, much less narrowly define, what is encompassed within utility services. Since the enactment of section 168 MACRS (Tax Reform Act of 1986) specifically eliminated for depreciation purposes the distinction between asset classes based on whether or not property was

public utility (regulated) property, the status of a taxpayer is irrelevant in determining the use of the property. See also Section 5.03 of Revenue Procedure 87-56.

CONCLUSION

Since the Plant is an asset used in the steam power production of electricity for sale as specifically described in Asset Class 49.13 of Rev. Proc. 87-56, the Plant is properly classified in Asset Class 49.13.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.