Internal Revenue Service

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Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:7
PLR-104930-07
Date:
September 20, 2007

Re: Request for ruling under section 168(h)(6)

Taxpayer =
Date 1 =

Dear :

This letter responds to a letter dated January 24, 2007, and supplemental correspondence, submitted by Taxpayer requesting a ruling under section 168(h)(6) of the Internal Revenue Code.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer is a limited liability company that is taxed as a partnership for federal income tax purposes. Since Date 1, Taxpayer has been engaged in the transmission of electric energy to utilities, power marketing companies, and other wholesalers of electricity in several states. Taxpayer is subject to cost-of-service, rate-of-return regulation by the Federal Energy Regulatory Commission ("FERC").

Taxpayer's members include several regulated public utilities principally engaged in the purchase, production, distribution, and sale of electric energy to residential, commercial, industrial, and wholesale customers. Many of these members are subject to regulation by FERC and by state regulators.

In addition to regulated public utilities, Taxpayer's members include many municipalities and municipal electric utilities. These members are not subject to federal or state income or franchise taxation ("tax-exempt members").

Under the current operating agreement, the income, profit, gain, loss, and expense (and all items contained therein) are allocated to Taxpayer's members in accordance with their respective percentage interests in Taxpayer (subject to any adjustment necessary to comply with the requirements of section 704(b) and (c)). For this purpose, each member's percentage interest is determined by dividing the number of units each member owns in Taxpayer by the total number of such units then outstanding ("ownership percentage"), resulting in the pro rata allocation of Taxpayer's taxable income, profits, gains, losses, and expenses.

The allocable profits of Taxpayer increase the tax liabilities of the members subject to federal or state income or franchise taxation ("taxable members"). For purposes of the regulatory treatment of taxes, FERC treats Taxpayer as an extension of its corporate owners. Taxpayer currently recovers its regulated tax expense through the rates set by FERC. Consequently, FERC allows Taxpayer to recover its members' federal and state income and franchise tax expense attributable to Taxpayer's operations as a component of Taxpayer's cost of service charges to its customers.

Under Taxpayer's current operating agreement, the portion of the rates charged by Taxpayer to its customers attributable to the recovery of the members' federal and state income and franchise tax expense (the "Tax Expense Recovery Income") is currently allocated pro rata among all of the members, whether taxable or tax-exempt, based upon each member's ownership percentage. Consequently, the tax-exempt members are allocated a portion of the Tax Expense Recovery Income although the tax-exempt members are not being reimbursed for any actual tax expense incurred by such members.

Taxpayer seeks to revise its current operating agreement to allocate its Tax Expense Recovery Income only to those members that are subject to federal and state income and franchise tax. The allocation would be pro rata among those members in proportion to each such member's ownership percentage (that is, the allocation of Tax Expense Recovery Income will be made based upon the ratio of each taxable member's ownership percentage over the sum of all taxable members' ownership percentages). If this change is implemented, no portion of the Tax Expense Recovery Income would be allocated to the tax-exempt members. However, to the extent a tax-exempt member can demonstrate liability for taxes with respect to its allocated portion of Taxpayer's income, such tax-exempt member will be allocated a corresponding amount of Tax Expense Recovery Income. Taxpayer would continue to allocate all other items of gross income, gain, loss, deduction, and expense proportionately to each member, whether taxable or tax-exempt, in accordance with that member's ownership percentage.

Taxpayer represents that it will implement the special allocation of its Tax Expense Recovery Income to conform to FERC's Policy Statement on Income Tax

Allowances issued May 4, 2005. Taxpayer further represents that the special allocation of its Tax Expense Recovery Income is entirely consistent with the FERC policies underlying, and will be in compliance with, FERC's Policy Statement on Income Tax Allowances.

Taxpayer also represents that the special allocation of its Tax Expense Recovery Income solely to those members that are actually subject to federal and applicable state income tax with respect to their allocable portion of Taxpayer's taxable income in proportion to each such member's ownership percentage has substantial economic effect for purposes of section 704(b)(2).

RULING REQUESTED

If the allocations of Taxpayer's other items of income, gain, loss, deduction, and credit constitute qualified allocations for purposes of section 168(h)(6) and if the special allocation of Tax Expense Recovery Income (as described below) has substantial economic effect for purposes of section 704(b)(2), Taxpayer requests a ruling that the special allocation of Tax Expense Recovery Income solely to its taxable members, in proportion to each such taxable member's ownership percentage calculated solely with respect to the aggregate units held by all such taxable members, will be treated as constituting a qualified allocation for purposes of section 168(h)(6) and no depreciable property that is subject to section 168 and owned by Taxpayer will be treated as tax-exempt use property for purposes of section 168(h)(6).

LAW AND ANALYSIS

The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in section 168(a) and the other method is the alternative depreciation system in section 168(g).

Pursuant to section 168(g)(1)(B), the depreciation deduction provided by section 167(a) for tax-exempt use property is determined under the alternative depreciation system. The determination of whether property is tax-exempt use property is made under section 168(h).

Section 168(h)(6)(A) provides that for purposes of the section 168(h), if (i) any property which (but for section 168(h)(6)(A)) is not tax-exempt use property is owned by a partnership which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and (ii) any allocation to the tax-exempt entity of partnership items is not a qualified allocation, an amount equal to the tax-exempt entity's proportionate share of such property shall (except as provided in section 168(h)(1)(D)) be treated as tax-exempt use property.

Section 168(h)(6)(B) provides that for purposes of section 168(h)(6)(A), the term "qualified allocation" means any allocation to a tax-exempt entity which (i) is consistent with such entity's being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership, and (ii) has substantial economic effect within the meaning of section 704(b)(2).

Section 168(h)(6)(C) provides that for purposes of section 168(h)(6)(A), a tax-exempt entity's proportionate share of any property owned by a partnership shall be determined on the basis of such entity's share of partnership items of income or gain (excluding gain allocated under section 704(c)), whichever results in the largest proportionate share. If a tax-exempt entity's share of partnership items of income or gain (excluding gain allocated under section 704(c)) may vary during the period such entity is a partner in the partnership, such share shall be the highest share such entity may receive.

Section 168(j) of the 1954 Code is the predecessor to section 168(h) of the 1986 Code. The House-Senate Conference Committee Report that accompanies the 1986 Act provides that the House bill and the Senate amendment are followed with respect to tax-exempt use property rules in section 168(h). See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-44 (1986), 1986-3 C.B. (Vol. 4) 44. The Senate amendment retains the tax-exempt use property rules of former section 168(j). See S. Rep. No. 313, 99th Cong., 2d Sess. 103 (1986), 1986-3 C.B. (Vol. 3) 103.

Section 1.168(j)-1T, Q&A-22(i) of the temporary Income Tax Regulations provides that a qualified allocation means any allocation to a tax-exempt entity which is consistent with such entity's being allocated the same share (i.e., the identical percentage) of each and every item of partnership income, gain, loss, deduction, credit, and basis during the entire period such entity is a partner. Except as provided in Q&A-23, an allocation is not qualified if it does not have substantial economic effect under section 704(b). However, for purposes of the two preceding sentences, items allocated under section 704(c) (relating to contributed property) are not taken into account. An allocation is not a "qualified allocation" if the partnership agreement provides for, or the partners have otherwise formally or informally agreed to, any change (regardless of whether such change is contingent upon the happening of one or more events) in the tax-exempt entity's distributive share of income, gain, loss, deduction, credit, or basis at any time during the entire period the tax-exempt entity is a partner.

Section 1.168(j)-1T, Q&A-24 provides that the Internal Revenue Service will accept rulings on the question of whether an allocation is a "qualified allocation" for purposes of former section 168(j)(9). One requirement of a qualified allocation is that such allocation must have substantial economic effect under section 704(b)(2). Currently, the Service will not rule on the question of whether an allocation has substantial economic effect under section 704(b)(2). Therefore, unless and until this policy is changed, a ruling request regarding a qualified allocation must contain a representation that the subject allocation has substantial economic effect.

The legislative history of former section 168(j) provides an example of an allocation in which a particular item is excluded or segregated. The example involves a U.S. corporation and a foreign country that are equal partners in a partnership created under the laws of that foreign country. Under those laws, the U.S. corporation's share of the partnership's profits are taxed, but not the foreign government's share. However, the tax is imposed on and paid by the partnership rather than the U.S. corporation partner directly. Under the partnership agreement, all partnership items are allocated equally between the two partners except that the tax expense is allocated to the U.S. corporation, and cash distributions to the partners reflect that allocation. Assuming those allocations possess substantial economic effect, the conferees do not intend that the partnership agreement be treated as containing an unqualified allocation. See H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 792 (1984), 1984-3 C.B. (Vol. 2) 46.

The FERC Policy Statement on Income Tax Allowances allows an income tax allowance for all entities or individuals owning public utility assets, provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets. Thus, a tax-paying corporation, a partnership, a limited liability corporation, or other pass-through entity would be permitted an income tax allowance on the income imputed to the corporation, or to the partners or the members of pass-through entities, provided that the corporation or the partners or the members have an actual or potential income tax liability on that public utility income. FERC Docket No. PL05-5-000 (May 4, 2005).

In the instant case, Taxpayer represents that it has both tax-exempt members and persons who are not tax-exempt members as partners. Taxpayer also represents that FERC allows Taxpayer to recover its members' federal and state income and franchise tax expense attributable to Taxpayer's operations as a component of Taxpayer's cost of service charges to its customers. The particular income item that is the subject of this letter ruling is the Tax Expense Recovery Income, which is the portion of the rates charged by Taxpayer to its customers attributable to the recovery of the members' federal and state income and franchise tax expense. Taxpayer will implement a special allocation of this particular income item. Under the special allocation, the Tax Expense Recovery Income will be allocated solely to Taxpayer's taxable members based upon the ratio of each taxable member's ownership percentage over the sum of all taxable members' ownership percentages. Taxpayer represents that it will implement the special allocation of its Tax Expense Recovery Income to conform to FERC's Policy Statement on Income Tax Allowances and that this special allocation is in compliance with FERC's Policy Statement on Income Tax Allowances. Moreover, Taxpayer represents that the special allocation of its Tax Expense Recovery Income has substantial economic effect for purposes of section 704(b)(2).

CONCLUSIONS

Based solely on the facts and representations submitted and the relevant law as set forth above, we conclude that if the allocations of Taxpayer's other items of income, gain, loss, deduction, and credit constitute qualified allocations for purposes of section 168(h)(6) and if the special allocation of Tax Expense Recovery Income (as described below) has substantial economic effect for purposes of section 704(b)(2), the special allocation of Tax Expense Recovery Income solely to its taxable members, in proportion to each such taxable member's ownership percentage calculated solely with respect to the aggregate units held by all such taxable members, will be treated as constituting a qualified allocation for purposes of section 168(h)(6) and no depreciable property that is subject to section 168 and owned by Taxpayer will be treated as tax-exempt use property for purposes of section 168(h)(6).

Except as specifically set forth above, we express no opinion concerning the federal income tax consequences of the facts described above under any other provisions of the Code. Specifically, no opinion is expressed or implied on: (i) whether the special allocation of Taxpayer's Tax Expense Recovery Income has substantial economic effect or is in compliance with FERC's Policy Statement on Income Tax Allowances issued on May 4, 2005, or (ii) whether the allocations of Taxpayer's other items of income, gain, loss, deduction, and credit constitute qualified allocations for purposes of section 168(h)(6).

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

Sincerely,

Kathleen Reed

Kathleen Reed
Chief, Branch 7
Office of Associate Chief Counsel
(Income Tax and Accounting)

Enclosures:
Copy of this letter
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