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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B03
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Date:
October 11, 2011

TY:

LEGEND:

Parent =

Power Company =

Power Plant =

Local Power Company =

Sub A =

Sub B =

Taxpayer =

Partner =

Buyer =

Original License Commencement Date =

Original License Expiration Date =

New License Commencement Date =

New License Issuance Date =

New License Expiration Date =

Power Company Incorporation Date =

Original PPA Date =

Original PPA Expiration Date =

New PPA Date =

New PPA Effective Date =

New PPA Expiration Date =

Reorganization Date =

Taxpayer Formation Date =

Sale Agreement Execution Date =

Sale Agreement Effective Date =

$A =

$B =

X% =

Dear :

This is in response to your letter dated . In your letter, you requested that the IRS rule that the right to buy power from Power Company, held on the date of sale by Parent's wholly-owned subsidiary, Taxpayer, is a capital asset under section 1221 of the Internal Revenue Code in the hands of Taxpayer, and that any gain from the assignment of such right to Buyer qualifies as capital gain.

FACTS

Parent, a corporation, is the common parent of an affiliated group of corporations that file a consolidated return for federal tax purposes. It is engaged in the business of electric power generation and distribution. Power Company, a corporation, is the owner and operator of the Power Plant, under a license from the Federal Energy Regulatory Commission ("FERC").

Power Company's original FERC license for the Power Plant was issued on Original License Commencement Date for a -year term that expired on Original License Expiration Date. Power Company applied for renewal of the FERC license for the Power Plant. Between Original License Expiration Date and New License Commencement Date, Power Company operated the Power Plant under an annual FERC license. On New License Issuance Date, FERC issued a new license to Power Company for the Power Plant effective New License Commencement Date and expiring on New License Expiration Date.

Power Company was incorporated on Power Company Incorporation Date, with two stockholders: Local Power Company, which owned of the total authorized stock of Power Company, and Partner, which owned of the total authorized stock of Power Company. On Original PPA Date, Local Power Company merged into Sub A, a wholly-owned subsidiary of Parent. As a result, Sub A acquired Local Power Company's stock interest in Power Company. After this merger, Partner retained its stock interest in Power Company and Sub A owned of the total authorized stock of Power Company.

Also on the Original PPA Date, Sub A, Partner, and Power Company entered into a power purchase agreement (the "Original PPA"). Pursuant to the Original PPA, Sub A and Partner are entitled to purchase all the capacity and energy available from the Power Plant. The Original PPA entitled Sub A and Partner to purchase and , respectively, of the total capacity and energy available from the Power Plant.

On the New PPA Date, Sub A, Partner, and Power Company entered into a power purchase agreement effective on the New PPA Effective Date (the "New PPA"), which superseded and replaced the Original PPA. Pursuant to the New PPA, Sub A and Partner are entitled to purchase all the capacity and energy available from the Power Plant. The New PPA entitled Sub A and Partner to purchase and , respectively, of the total capacity and daily energy available from the Power Plant. The New PPA provides that it shall remain in force until the expiration of Power Company's FERC license for the Power Plant on the New PPA Expiration Date and "for such time thereafter as [Power Company] is the licensee from the Federal Energy Regulatory Commission of the [Power Plant]."

Sub A paid no consideration to Power Company for the right to purchase capacity and energy from the Power Plant under the Original PPA and the New PPA.

Effective on the Reorganization Date, Parent underwent a divisive reorganization (i.e., a drop down of assets followed by a spinoff of Parent's generation assets) under § 368(a)(1)(D) of the Internal Revenue Code. The transaction was tax free to Parent under § 355, tax free to Sub A under § 361, and tax free to Sub B, a direct and wholly-owned subsidiary of Sub A, under § 1032.

As part of this divisive reorganization, Sub A transferred its stock interest in Power Company, and assigned its rights and obligations under the New PPA, to Sub B. Sub B took a carryover basis of zero in the New PPA. Parent then caused Sub B to transfer the stock interest in Power Company and assign the rights and obligations under the New PPA down a chain of entities that are disregarded as separate from their owners under § 301.7701-2(c)(2)(i) of the Income Tax Regulations to Taxpayer. Taxpayer took a carryover basis of zero in the New PPA from Sub B. Taxpayer did not pay any consideration for the assignment of the New PPA.

Taxpayer, a limited liability company, is wholly owned by Sub B and is a disregarded entity for federal income tax purposes. Taxpayer was formed on Taxpayer Formation Date in anticipation of Parent's divisive reorganization in order to receive Parent's business. Taxpayer is an exempt wholesale generator authorized to sell electric energy, capacity, and certain ancillary services at market-based rates.

Parent represents that the rights and obligations of Sub A under the New PPA were transferred to Sub B in a transaction described in § 197(f)(2)(B) and § 1.197-2(g)(2)(ii)(C).

Taxpayer entered into a purchase and sale agreement dated Sale Agreement Execution Date, effective as of the agreement's closing date on Sale Agreement Effective Date, in which Taxpayer sold its entire stock interest in Power Company to Buyer. As part of the purchase and sale agreement, Taxpayer also entered into an assignment and assumption agreement in which Taxpayer assigned its rights and obligations under the New PPA to Buyer. The total consideration Buyer paid to Taxpayer for the sale of its Power Company stock and the assignment of its rights and obligations under the New PPA was $A. The purchase and sale agreement does not allocate this amount between the sale of the Power Company stock and the assignment of the New PPA. However, Parent has obtained a valuation concluding that X% of the $A (or $B) is allocable to the assignment of Taxpayer's rights and obligations under the New PPA. Because Taxpayer's basis in the power purchase right is zero, Taxpayer will recognize a gain on the assignment of its rights and obligations under the New PPA of $B.

Parent represents that: (i) FERC licenses generally are always renewed; (ii) according to its outside FERC counsel, as long as a FERC licensee has a good compliance record as a licensee, then it is virtually certain that the licensee can relicense its facility, albeit with more onerous environmental conditions, so long as the licensee complies with the

notice and application deadlines of the Federal Power Act (“FPA”); (iii) absent the rare instance of a government takeover or abandonment of a power project, FERC licenses almost always continue through the renewal process; and (iv) Power Company has a good compliance record as a licensee. Parent states that to the best of its knowledge, it believes that Power Company fully intends to renew its current FERC license for the Power Plant, which expires on the New License Expiration Date.

LAW AND ANALYSIS

Section 1222 provides that capital gain or loss is generated upon a sale or exchange of a capital asset.

Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of eight listed exceptions: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in section 167, or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; (5) certain publications of the United States Government; (6) certain commodities financial derivatives; (7) certain hedging transactions; and (8) supplies of a type regularly consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

None of the exceptions listed in § 1221 to qualification as a capital asset apply, with the possible exception of § 1221(a)(2), property of a character which is subject to the allowance for depreciation provided in § 167.

Is the New PPA property of a character that is subject to the allowance for depreciation provided under § 167?

The first issue is whether Taxpayer’s right to purchase capacity and energy under the New PPA is property of a character that is subject to the allowance for depreciation provided under § 167.

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

Section 1.167(a)-3(a) provides that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. However, an intangible asset, the useful life of which is not limited, is not subject to an allowance for depreciation. Thus, an intangible asset is depreciable under § 167(a) if it has a determinable useful life.

The New PPA provides that it shall remain in force until the expiration of Power Company's FERC license for the Power Plant on New License Expiration Date and "for such time thereafter as [Power Company] is the licensee from the Federal Energy Regulatory Commission of the [Power Plant]." Consequently, the New PPA has a life that is coterminous with Power Company's FERC license for the Power Plant.

Further, Parent represents that, according to its outside FERC counsel, as long as a FERC licensee has a good compliance record as a licensee, then it is virtually certain that the licensee can relicense its facility, albeit with more onerous environmental conditions, so long as the licensee complies with the notice and application deadlines of the FPA. Parent also represents that Power Company has a good compliance record as a licensee.

To renew a FERC license for a hydroelectric plant, the existing licensee must notify FERC whether the licensee intends to file an application for a new license or not. 16 U.S.C. § 808(b)(1). This notice must be submitted at least 5 years before the expiration of the existing license. Id. Further, the existing licensee must file the application for a new license with FERC at least 24 months before the expiration of the term of the existing license. 16 U.S.C. § 808(c)(1).

Power Company applied for a renewal of its original FERC license for the Power Plant, which expired on Original License Expiration Date, and as a result, FERC issued a new license to Power Company for Power Plant for a -year term expiring on New License Expiration Date. Parent states that to the best of its knowledge, Parent believes that Power Company fully intends to renew its current license for the Power Plant.

Several courts have held that an FCC broadcasting license does not have a limited useful life for depreciation purposes because there is a high probability of renewal of the license by the FCC. See Forward Communications Corp. v. United States, 608 F.2d 485 (1979) (amortization disallowed for FCC broadcasting license due to high probability of an indefinite succession of automatic renewals); see also Times-World Corporation v. United States, 251 F.Supp. 43 (W.D. Va. 1966). The same reasoning was used in Nachman v. Commissioner, 191 F.2d 934, 936 (5th Cir. 1951) (denied depreciation deduction for the cost of a liquor license because there was "no indication that the City would depart from its custom of renewing existing licenses") and in Ueckler v. Commission, 81 T.C. 983, 993-995 (1983) (denied depreciation deduction for the cost of a federal grazing privilege license with preferential rights of renewal).

A FERC license for a hydroelectric plant is analogous to an FCC broadcasting license and other renewable licenses issued by governmental agencies that have a high certainty of renewal. Consequently, a FERC license for a hydroelectric plant has an indeterminable useful life for depreciation purposes. Because the New PPA has a life

that is coterminous with Power Company's FERC license for the Power Plant, the New PPA also has an indeterminable useful life for depreciation purposes.

Is the New PPA an Amortizable Section 197 intangible?

Even though we have concluded that the New PPA has an indeterminable useful life for depreciation purposes, a second issue is whether the New PPA is property of a character subject to depreciation under § 167 if it is an amortizable section 197 intangible.

Section 197(f)(7) provides that for purposes of Chapter 1 of the Code, any amortizable section 197 intangible shall be treated as property which is of a character subject to the allowance for depreciation provided in § 167.

Section 197(c)(1) defines the term "amortizable section 197 intangible" as generally meaning any section 197 intangible that is acquired by the taxpayer after August 10, 1993, and that is held in connection with the conduct of a trade or business or an activity described in § 212.

However, § 197(c)(2) provides that the term "amortizable section 197 intangible" shall not include any section 197 intangible that is not described in § 197(d)(1)(D), (E), or (F), and that is created by the taxpayer.

Section 197(f)(2)(A) provides that in the case of any section 197 intangible transferred in a transaction described in § 197(f)(2)(B), the transferee shall be treated as the transferor for purposes of applying § 197 with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. The transactions described in § 197(f)(2)(B) are (i) any transaction described in § 332, 351, 361, 721, 731, 1031, or 1033, and (ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

Section 1.197-2(g)(2) provides the rules relating to § 197(f)(2)(A) and (B). Section 1.197-2(g)(2)(ii)(A) provides that if a section 197 intangible is transferred in a transaction described in § 1.197-2(g)(2)(ii)(C), the transfer is disregarded in determining (1) whether, with respect to so much of the intangible's basis in the hands of the transferee as does not exceed its basis in the hands of the transferor, the intangible is an amortizable section 197 intangible, and (2) the amount of the deduction under § 197 with respect to such basis.

Section 1.197-2(g)(2)(ii)(B) provides, in relevant part, that if the intangible was not an amortizable section 197 intangible in the hands of the transferor, the transferee's adjusted basis, to the extent it does not exceed the transferor's adjusted basis, cannot be amortized under § 197. Section 1.197-2(g)(2)(ii)(B) further provides that the rules of

§ 1.197-2(g)(2)(ii) also apply to any subsequent transfers of the intangible in a transaction described in § 1.197-2(g)(2)(ii)(C).

Section 1.197-2(g)(2)(ii)(C) provides that the transactions described in this paragraph are: (1) any transaction described in § 332, 351, 361, 721, or 731; and (2) any transaction between corporations that are members of the same consolidated group immediately after the transaction.

In this case, Sub A originally acquired the right to purchase of the capacity and energy from the Power Plant under the Original PPA on Original PPA Date. The New PPA superseded the Original PPA. Under the New PPA, Sub A continued to have the right to purchase of the capacity and energy from the Power Plant. Because Sub A acquired the right to purchase of the capacity and energy from the Power Plant prior to August 10, 1993, the right is not an amortizable section 197 intangible in the hands of Sub A.

On Reorganization Date, the rights and obligations of Sub A under the New PPA were transferred to Sub B in a transaction described in § 197(f)(2)(B) and § 1.197-2(g)(2)(ii)(C). Sub B then transferred the rights and obligations under the New PPA to Taxpayer, a limited liability company that is wholly owned by Sub B and is disregarded as an entity separate from Sub B for federal income tax purposes. Sub B and Taxpayer did not pay any consideration for this power purchase right. Accordingly, pursuant to § 1.197-2(g)(2)(ii)(B), the right to purchase of the capacity and energy from the Power Plant under the New PPA is not an amortizable section 197 intangible in the hands of Sub B and Taxpayer. Thus, we conclude that Taxpayer's right to purchase capacity and energy under the New PPA is not property of a character that is subject to the allowance for depreciation provided under § 167, and thus the New PPA is a capital asset.

Was the assignment of the New PPA a sale or exchange under §1222?

Finally, to qualify for capital gain treatment, there must be a "sale or exchange" of property amounting to a capital asset. § 1222. A "sale" has been defined as a "transfer of property for a fixed price in money or its equivalent." Commissioner of Internal Revenue v. Brown, 380 U.S. 563, 571 (1965). The Tax Court has held that the terms "sale or exchange" in § 1222 include "transactions in which all rights to property or all rights to a portion thereof have been transferred permanently from one party to another", including assignment of rights under a contract. Foy v. Commissioner, 84 T.C. 50, 73 (1985). Taxpayer entered into a purchase and sale agreement on Sale Agreement Execution Date in which Taxpayer sold its entire stock interest in Power Company to Buyer. On the same date, Taxpayer also entered into an assignment and assumption agreement in which Taxpayer assigned its rights and obligations under the New PPA to Buyer. Total consideration for the two transactions was $A, and Parent has obtained a valuation concluding that $B of the total is allocable to the assignment of

Taxpayer's rights and obligations under the New PPA. Parent represents that the assignment and assumption agreement constitutes a "sale or exchange" under § 1222 and that an assignment and assumption agreement is commonly used in its industry to sell a contract right. Under the rule of Foy, the assignment of the New PPA for consideration is a "sale or exchange" under § 1222 because all rights under the New PPA, a capital asset, were transferred to Buyer.

CONCLUSION

We conclude that the New PPA is a capital asset in the hands of Taxpayer for purposes of § 1221 and that any gain from the assignment of such right to Buyer qualifies for capital gain treatment.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal income tax consequences of any aspect of any transaction or item discussed or referenced in this ruling.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any 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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Robert Casey
Senior Technician Reviewer, Branch 3
(Income Tax & Accounting)