Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

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CC:ITA:B01
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Date:
February 15, 2013

Attn:

Legend

Sub =
Parent =
County1 =
County2 =
State =
Rules =

Commission =
D1 =
x =
y =

Dear :

This responds to your letter dated July 25, 2012, requesting rulings on behalf of Sub. Parent requests rulings on the federal income tax consequences of certain "Up Front Incentive" payments ("UFIs") made by Sub.

RULINGS REQUESTED

(1) The annual amount of UFIs made by Sub is currently deductible under § 162(a) of the Internal Revenue Code.

(2) The annual amount of UFIs made by Sub is not capitalized under § 263(a).

FACTS

Parent is the parent corporation of a group of affiliated corporations that file a consolidated return for U.S. federal income tax purposes. Sub, a member of the consolidated group, is an electric transmission and distribution company serving retail customers in County1 and County2 in State.

As an electric utility operating in State, Sub is subject to the regulatory authority of the Commission. On D1, the Commission adopted the Rules requiring electric utility companies operating in State to produce a certain amount of renewable energy each year. Compliance with the renewable energy requirements in the Rules is measured by "renewable energy credits" ("RECs"). A single REC represents x kWh of renewable energy generated by an renewable energy resource. A utility in State meets its renewable energy requirements by retiring a sufficient amount of RECs to satisfy the renewable energy requirements. Under the Rules, at least a certain percentage of the renewable energy must come from "distributed energy"—that is, energy created by equipment owned by the particular utility's customer and located on that customer's premises. As a result, Sub was required to implement a plan to comply with the Rules, and to allocate specific funding for each segment of the plan, including the distributed energy requirement.

To meet its distributed energy requirement, Sub makes UFIs to incentivize customers (both residential and commercial) to purchase and install certain systems. UFIs are one-time, up-front payments based on potential energy production and made to a customer who agrees to purchase, install, and maintain an eligible system. The amount of UFI payments is regulated by the Commission and is subject to change year to year and also mid-year. UFI rates are not based on the value of the renewable energy or the RECs actually produced.

Under the Rules, a REC is defined as the unit created to track kWh derived from or kWh equivalent of conventional energy resources displaced by . The Rules also provide that a REC is the "property" of the owner of the .

RECs derived from distributed energy ("distributed energy RECs") must be assigned to the Utility under the UFI contracts. The customer does not agree to produce any certain minimum number of RECs, and no refund or partial refund of the UFI is required as long as the System is maintained and not removed.

Parent represents on behalf of Sub that RECs are merely used as a scorekeeping mechanism for measuring a utility's compliance with the Rules. The distributed energy RECs are retired by Sub to satisfy its distributed energy requirements under the Rules. There is no market for distributed energy RECs in State or elsewhere. No other utility would want the customer's distributed energy RECs because they would not be

distributed energy RECs as to the other utility (i.e. they would not have been produced by a customer of that other utility). To date, neither Sub nor any other subsidiary of Parent has ever sold, transferred, or traded a distributed energy REC. The assignment of the RECs provides no long-term benefit to Sub other than allowing Sub to comply with state law.

LAW AND ANALYSIS

Ruling Request 1

Section 162(a) provides generally that taxpayers may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See also § 1.162-1(a) of the Income Tax Regulations. In order to be deductible under § 162, an expenditure must be (1) paid or incurred during the taxable year, (2) related to carrying on a trade or business, and (3) ordinary and necessary for the trade or business. Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345, 352 (1971).

The term "ordinary" refers to an expenditure that is normal, usual, or customary. Deputy v. du Pont, 308 U.S. 488, 495 (1940). An expenditure may be ordinary if it is commonly and frequently incurred in the type of business involved. Id. (citing Welch v. Helvering, 290 U.S. 111, 114 (1933)).

The term "necessary" means appropriate and helpful to the development of the taxpayer's business. Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (quoting Welch, 290 U.S. at 113); Commissioner v. Heininger, 320 U.S. 467, 471 (1943). A payment may be appropriate and helpful to the development of a taxpayer's business if that payment is mandated by a state governmental entity which confers upon the taxpayer the right to conduct its business in that state. See Rothner v. Commissioner, T.C. Memo. 1996-442.

The UFIs that Sub pays to its customers are currently deductible as ordinary and necessary business expenses. Sub provides electric service in State, and is subject to the regulatory authority of the Commission. Sub makes UFIs to customers in order to comply with the Rules implemented by the Commission. The Commission's imposition and oversight of the Rules generally and, in particular, the UFI requirements show that the UFIs are ordinary expenses of Sub. Moreover, as an electric utility operating in State, Sub is subject to the regulatory authority of the Commission, and must comply with the renewable energy requirements in the Rules imposed by the Commission. The UFIs are paid in order to comply with rules of the governmental entity regulating Sub's right to conduct its business operations in State, and failure to make those UFIs could jeopardize Sub's continued business operations in State. The UFIs are appropriate and helpful to Sub's business, and therefore, the UFIs are necessary expenses.

Accordingly, we conclude that the UFIs are ordinary and necessary business expenses, and are currently deductible under § 162.

Ruling Request 2

Under § 161, if a cost is a capital expenditure, the capitalization rules of § 263 take precedence over the deduction rules of § 162. Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1974). Therefore, a capital expenditure cannot be deducted under § 162, regardless of whether the expenditure is ordinary and necessary in carrying on a trade or business.

Section 263(a) provides generally that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate or any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 1.263(a)-4 provides the rules for applying § 263(a) to amounts paid to acquire or create intangibles. In relevant part, § 1.263(a)-4(b)(1) provides that a taxpayer must capitalize an amount paid to acquire or create an intangible, or to create or enhance a separate and distinct intangible asset.

First, we address whether Sub's payments to customers under the UFI contracts are required to be capitalized as costs to acquire an intangible. Under § 1.263(a)-4(c), a taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Sub is not acquiring an intangible within the scope of § 1.263(a)-4(c).

Though the Rules provide that a REC is the "property" of the owner of the renewable energy resource, the Rules also provide that RECs were created to track kWh derived from . In this case, the distributed energy RECs have no value and are used only to track the amount of renewable energy produced during the year. Therefore, UFIs are not required to be capitalized under § 1.263(a)-4(c).

Second, we address whether Sub's payments to customers under the UFI contracts are required to be capitalized as costs to create an intangible. Section 1.263(a)-4(b)(1)(ii) provides that a taxpayer must capitalize an amount paid to create an intangible described in § 1.263(a)-4(d). Sub is not creating an intangible described under § 1.263(a)-4(d).

Finally, we address whether Sub's payments to customers under the UFI contracts are required to be capitalized as costs to create or enhance a separate and distinct intangible asset. The term "separate and distinct intangible asset" is defined as a property interest of ascertainable and measurable value in money's worth that is subject

to protection under applicable state, federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. Section 1.263(a)-4(b)(3)(i).

Section 1.263(a)-4(b)(3)(ii) provides that amounts paid to another party to create, originate, enter into, renew or renegotiate an agreement with that party that produces rights or benefits for the taxpayer are treated as amounts that do not create a separate and distinct intangible asset. The UFI contracts are agreements that produce rights or benefits for the taxpayer and, therefore, cannot be separate and distinct intangible assets as defined by § 1.263(a)-4(b)(3).

Accordingly, the UFIs that Sub pays to its customers are not required to be capitalized as costs to create or enhance a separate and distinct intangible asset under § 1.263(a)-4(b)(1)(iii).

CONCLUSIONS

(1) The annual amount of UFIs made by Sub is currently deductible under § 162(a).

(2) The annual amount of UFIs made by Sub is not capitalized under § 263(a).

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

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code 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 representatives.

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,

Lewis K Brickates
Branch Chief, Branch 1
Office of Associate Chief Counsel
(Income Tax & Accounting)