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Date:
July 17, 2015

Re:

Legend

Parent =

Taxpayer =

City =

State1 =

State2 =

Date1 =

Date2 =

Storage Device =

Unit =

A =

B =

C =

D =

E =

F =

G =

H =

I =

Dear :

This letter responds to a letter dated December 18, 2014, and subsequent correspondence, submitted by Taxpayer, requesting a letter ruling that certain of Taxpayer's depreciable tangible property used in its business activity is 7-year property described in § 168(e)(3)(C)(v) of the Internal Revenue Code.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer, a State1 corporation, joins in the filing of a consolidated federal income tax return headed by Parent. A, a State1 limited liability company, is a wholly-owned subsidiary of Taxpayer. B, a State1 limited liability company, is a wholly-owned subsidiary of A. Neither A nor B has elected to be classified as an association taxed as a corporation for federal income tax purposes and, as a result, they are both disregarded as entities separate from Taxpayer. Taxpayer, A, and B are not utilities.

C, an unrelated third party, operates an electric grid transmission system in City in State2. The grid transmits electricity produced by power generation facilities that supply energy to the C service territory. This electric system must maintain a grid frequency of 60 hertz to operate safely and efficiently. There are several companies providing frequency regulation services to C to maintain the grid frequency of 60 hertz. Because there is more frequency regulation service available to C than C requires at any given time, C selects which companies to employ for frequency regulation services using a bidding system.

B owns and operates a Storage Device whose primary purpose is to provide frequency regulation services to C. B has provided such services to C since Date1. Because A and B are disregarded entities for federal tax purposes, Taxpayer is deemed to own this Storage Device for federal tax purposes.

The Storage Device could be located anywhere on C's grid. The Storage Device happens to be attached to a E kilovolt electrical distribution feeder line that belongs to D, a utility. This distribution feeder line is located adjacent to D's substation near City in State2.

The Storage Device consists of F Units. These Units are held in a shipping container that is connected to a combiner box that holds transformers that in turn is connected to the grid by G cables. Each Unit can operate at a rated capacity of up to H kilowatts, providing an aggregate total rated capacity of I megawatts. Each Unit can operate independently.

Taxpayer (through A and B) primarily uses the Storage Device near City in State2 to provide frequency regulation services to C by removing electricity from C's grid when its frequency is high, temporarily storing that electricity, and releasing the electricity back onto the grid when its frequency is low. The electricity is removed and released at the exact same point on C's grid. Although the Storage Device eventually releases almost all of the electricity back onto the grid, a small amount of electricity is lost while the electricity is held in the Storage Device. The majority of this electricity is lost when it escapes the Storage Device as heat. To account for this loss, C charges Taxpayer (through A and B) for the electricity that the Storage Device removes from the grid, and pays Taxpayer (through A and B) for the electricity that the Storage Device releases onto the grid. In both cases, Taxpayer (through A and B) and C pay wholesale prices for the electricity, which varies from hour to hour. Taxpayer (through A and B) does not anticipate making any significant profit or suffering any significant loss from this exchange of electricity. When electricity is moved from the grid to the Storage Device, ownership of that electricity shifts to Taxpayer (through A and B), and when the electricity is released back onto the grid, ownership is transferred back to C. All transfers of ownership occur at a revenue meter.

By letter dated May 5, 2015, Taxpayer represents that, from Date1 to Date2, all of B's revenue came from C's payments for B providing frequency regulation services to C by using the Storage Device near City in State2. B did not realize any income from the sale of electricity back to C (when taking into account the cost of such electricity). Because the Storage Device loses a small amount of the electricity that it stores, B actually spent more money to purchase electricity from C than it realized from selling electricity back to C.

RULING REQUESTED

Taxpayer requests the Internal Revenue Service issue the following ruling:

The Storage Device primarily used by Taxpayer to provide frequency regulation services is property with no class life under § 168 and, as a result, is 7-year property under § 168(e)(3)(C)(v).

LAW AND ANALYSIS

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

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168, which prescribes two methods for determining depreciation allowances: (1) the general depreciation system in § 168(a); and (2) the alternative depreciation system in § 168(g). Under either depreciation system, a taxpayer computes the depreciation deduction by using a prescribed depreciation method, recovery period, and convention.

For purposes of § 168(a), the depreciation method, recovery period, and convention are determined by the property's classification under § 168(e). Pursuant to § 168(e)(1), property with a class life of 4 years or less is classified as 3-year property, property with a class life of more than 4 years but less than 10 years is classified as 5-year property, property with a class life of 10 years or more but less than 16 years is classified as 7-year property, property with a class life of 16 years or more but less than 20 years is classified as 10-year property, property with a class life of 20 years or more but less than 25 years is classified as 15-year property, and property with a class life of 25 years or more is classified as 20-year property.

Section 168(i)(1) defines the term "class life" as meaning the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former § 167(m) as if it were in effect and the taxpayer were an elector. Former § 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary which reasonably reflected the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations sets out the method for asset classification under former § 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is

classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.

Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowances under § 168. This revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The same item of depreciable property can be described in 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), in which case the item is classified in the asset category. See Norwest Corporation & Subsidiaries v. Commissioner, 111 T.C. 105 (1998) (item described in both an asset and an activity category (furniture and fixtures) should be placed in the asset category). Unless otherwise noted, the business activity asset classes described below are set forth in Rev. Proc. 87-56.

If there is not an asset class of Rev. Proc. 87-56 that describes the property or the business activity in which the property is primarily used and if the property is not otherwise classified under § 168(e)(2) or (3), the property is 7-year property pursuant to § 168(e)(3)(C)(v).

The first issue is whether any of the asset classes 00.11 through 00.4 of Rev. Proc. 87-56 includes the Storage Device. Of these asset classes, only asset class 00.4, Industrial Steam and Electric Generation and/or Distribution Systems, describes property involving electricity.

Asset class 00.4 of Rev. Proc. 87-56 includes assets, whether such assets are § 1245 property or § 1250 property, providing such assets are depreciable, used in the production and/or distribution of electricity with rated total capacity in excess of 500 Kilowatts and/or assets used in the production and/or distribution of steam with rated total capacity in excess of 12,500 pounds per hour for use by the taxpayer in its industrial manufacturing process or plant activity and not ordinarily available for sale to others. Assets in this class have a class life of 22 years and, as a result, are classified as 15-year property under § 168(e)(1).

In this case, the Storage Device is primarily used by Taxpayer to provide frequency regulation services to C. The Storage Device is not used by Taxpayer in its industrial manufacturing process or plant activity. Further, the Storage Device does not produce electricity and, for the reasons stated below, is not used in the distribution of electricity. Accordingly, the Storage Device is not property described in asset class 00.4. Consequently, none of the asset classes 00.11 through 00.4 of Rev. Proc. 87-56 describes the Storage Device.

The second issue is whether any of the asset classes 01.1 through 80.0 of Rev. Proc. 87-56 describes Taxpayer's business activity of providing frequency regulation services.

There are two asset classes that may apply to Taxpayer's business activity: asset class 49.14, Electric Utility Transmission and Distribution Plant, or asset class 57.0, Distributive Trades and Services.

Asset class 49.14 of Rev. Proc. 87-56 includes assets used in the transmission and distribution of electricity for sale and related land improvements. This asset class excludes initial clearing and grading land improvements as specified in Rev. Rul. 72-403, 1972-2 C.B. 102. Assets in this class have a class life of 30 years and, as a result, are classified as 20-year property under § 168(e)(1).

The Tax Court in PPL Corporation v. Commissioner, 135 T.C. 176 (2010), concluded that street light assets are not assets used in the distribution of electricity and, thus, not included in asset class 49.14 of Rev. Proc. 87-56. In reaching its conclusion, the Court looked at the definition of the word “distribution” as well as the primary use of the street light assets. The parties stipulated that distribution meant “the delivery of electric energy to customers” and “the final utility step in the provision of electric service to customers." The Court found this definition to be consistent with a standard definition of distribution. 135 T.C. at 183. The Court also stated that the “distribution of electricity seems to us to be the process by which electricity (the commodity) gets to final consumers.” Id. The Court found that street light assets could be disconnected from the distribution system without effecting electrical distribution to customers and they are distinct from distribution assets because they have a different purpose and function. On this last point, the Court found that distribution assets get final consumers electricity, service drops are the final part of the distribution of electricity to final consumers, and street light assets are not part of the service to get electricity to final consumers.

The transmission of electricity is “the process of moving high voltage electricity from power plants to distribution substations.” PPL Corporation, 135 T.C. at 178. Transmission is defined by the U.S. Energy Information Administration (EIA) and the North America Electric Reliability Corporation (NERC) as ‘”[a]n interconnected group of lines and associated equipment for the movement or transfer of electric energy between points of supply and points at which it is transformed for delivery to customers or is delivered to other electric systems.” EIA’s Glossary at www.eia.gov/glossary.index.cfm and Glossary of Terms Used in NERC Reliability Standards (updated May 19, 2015) at www.nerc.com/files/glossary_of_terms.pdf.

As mentioned under the first issue, the Storage Device is primarily used by Taxpayer to provide frequency regulation services to C. As a result, the Storage Device has a different purpose and function than electricity transmission and distribution

assets. If C does not use Taxpayer's Storage Device on a given day, the transmission of electricity is not affected because there are other companies providing frequency regulation services to C. Although the Storage Device is used to store electricity to be sold to C at a later time, we do not view the Storage Device as transmission or distribution equipment. Accordingly, Taxpayer's business activity of providing frequency regulation services to an unrelated third party is not described in asset class 49.14.

Asset class 57.0 of Rev. Proc. 87-56 includes assets used in wholesale and retail trade, and personal and professional services. Assets in this class have a class life of 9 years and, as a result, are classified as 5-year property under § 168(e)(1).

Asset class 57.0 was established by Rev. Proc. 80-15, 1980-1 C.B. 618, modifying Rev. Proc. 77-10, 1977-1 C.B. 548, and is derived, in part, from asset classes 50.0 (Wholesale and Retail Trade) and 70.2 (Personal and Professional Services) of Rev. Proc. 77-10.

Asset class 50.0 of Rev. Proc. 77-10 included: (1) assets used in carrying out the activities of purchasing, assembling, storing, sorting, grading, and selling of goods at both the wholesale and retail level, and (2) assets used in such activities as the operation of restaurants, cafes, coin-operated dispensing machines, and in brokerage of scrap metal.

Asset class 70.2 of Rev. Proc. 77-10 included: (1) assets used in the provision of personal services such as those offered by hotels and motels, laundry and dry cleaning establishments, beauty and barber shops, photographic studios and mortuaries; (2) assets used in the provision of professional services such as those offered by doctors, dentists, lawyers, accountants, architects, engineers, and veterinarians; (3) assets used in the provision of repair and maintenance services and those assets used in providing fire and burglary protection services; and (4) equipment or facilities used by cemetery organizations, news agencies, teletype wire services, frozen food lockers, and research laboratories.

In this case, Taxpayer primarily uses the Storage Device to provide frequency regulation services to C. Although Taxpayer does buy and sell electricity from and to C at wholesale prices, these transactions are ancillary to providing frequency regulation services. From Date1 to Date2, all of B's revenue came from C's payments for B providing frequency regulation services to C by using the Storage Device, and B spent more money to purchase electricity from C than it realized from selling electricity back to C. Effectively, over this period, the electricity purchases and sales were a cost of providing the frequency regulation services. Consequently, we do not view Taxpayer as engaged in a wholesale trade or retail trade activity for purposes of asset class 57.0 of Rev. Proc. 87-56.

However, we believe that the frequency regulation services provided by Taxpayer to an unrelated third party are of the type contemplated by asset class 57.0 of Rev. Proc. 87-56. Accordingly, the Storage Device primarily used by Taxpayer to provide frequency regulation services is included in asset class 57.0 and, consequently, has a class life of 9 years.

CONCLUSION

Based solely on the facts and representations and the relevant law and analysis set forth above, we conclude that the Storage Device primarily used by Taxpayer to provide frequency regulation services is property included in asset class 57.0 of Rev. Proc. 87-56 with a class life of 9 years and, as a result, is 5-year property under § 168(e)(1).

Except as specifically set forth above, no opinion is expressed or implied concerning the tax consequences of the facts described above under any other provisions of the Code (including other subsections of § 168).

This letter 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, we are sending a copy of this letter to Taxpayer's authorized representatives. We are also sending a copy of this letter to the appropriate operating division director.

Sincerely,

Kathleen Reed

KATHLEEN REED
Chief, Branch 7
Office of Associate Chief Counsel
(Income Tax and Accounting)

Enclosures (2):
copy of this letter
copy for section 6110 purposes