Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

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Date:
July 30, 2015

LEGEND:

Taxpayer	=
Parent	=
State A	=
State B	=
Commission A	=
Commission B	=
Commission C	=
Operator	=
X	=
Department	=
Facility	=
A	=
Director	=

Dear :

This letter responds to your representative's request dated March 31, 2015, supplemented by letter dated July 7, 2015, for a ruling on whether the Facility described below is classified as public utility property within the meaning of former section 46(f), § 168(i)(10), and the regulations promulgated thereunder for purposes of the application of the normalization rules to that Facility.

The representations set out in your letter follow.

Taxpayer, a wholly-owned subsidiary of Parent, is a public utility primarily engaged in the business of generating, transmitting, distributing, and selling electric power to customers in State A and State B. It is subject to regulation by Commission A, Commission B, and Commission C with respect to terms and conditions of services, including the rates it may charge for its services. All three Commissions establish Taxpayer's rates based on Taxpayer's costs, including a provision for a return on the capital employed by Taxpayer in its regulated business.

Taxpayer also has certain "non-jurisdictional" retail electricity customers whose rates are established by means of bi-lateral negotiations between Taxpayer and the customer rather than as tariffs established by regulatory authorities. These customers are primarily governmental agencies or entities located within State A. Among those non-jurisdictional customers is X, a United States government installation overseen by Department. Taxpayer currently provides electricity to X under several contracts. Taxpayer provides the utility service to X from its system assets and currently has no significant assets entirely dedicated to provision of services to X.

Department wishes to procure energy generated from renewable resources and has executed a Memorandum of Understanding with Taxpayer to do so. Under this memorandum Taxpayer will provide energy from renewable resources to X pursuant to a new contract to be negotiated between Taxpayer and Department. Under this contract, Taxpayer will develop, own, and operate the Facility, a solar electricity generator. The nameplate capacity rating of Facility is less than the minimum demand for electricity at X specified in the current contracts. Facility will be located in State B. Taxpayer will meter the power generated by Facility and include the monthly output as a separate charge for electricity provided to X. The electricity generated by Facility will be delivered into the transmission system controlled by Operator, a regional transmission organization which operates Taxpayer's transmission assets. The contract for the solar power generated by Facility will be for a term of A years with a single optional extension of A years. Taxpayer and Department have discussed the anticipated contract price of the electricity to be generated by Facility and provided to X. The contract will be "sole sourced" and not based on competitive bidding and the acceptability of the price for the electricity will be determined by Department based on whether the price is fair and reasonable to both parties.

Taxpayer requests that we rule that Facility does not constitute public utility property within the meaning of former section 46(f), § 168(i)(10), and the regulations promulgated thereunder.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

Section 168(i)(10) of the Code defines, in part, public utility property as property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility property was contained in § 167(l)(3)(A) and § 168(i)(10), which defined public utility property by means of a cross reference to § 167(l)(3)(A). The definition of public utility property is unchanged. Section 1.167(l)-1(b) provides that under § 167(l)(3)(A), property is public utility property during any period in which it is used predominantly in a § 167(l) public utility activity. The term "section 167(l) public utility activity" means, in part, the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in § 167(l)(3)(A). The term "regulatory body described in section 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

The definitions of public utility property contained in § 168(i)(10) and former § 46(f)(5) are essentially identical. Section 1.167(l)-1(b) restates the statutory definition providing that property will be considered public utility property if it is used predominantly in a public utility activity and the rates are regulated. Section 1.167(l)-1(b)(1) provides that rates are regulated for such purposes if they are established or approved by a regulatory body. The terms established or approved are further defined to include the filing of a schedule of rates with the regulatory body which has the power to approve such rates even though the body has taken no action on the filed schedule or generally leaves undisturbed rates filed.

The regulations under former section 46, specifically § 1.46-3(g)(2), contain an expanded definition of regulated rates. This expanded definition embodies the notion of rates established or approved on a rate of return basis. This notion is not specifically provided for in the regulations under former section 167. Nevertheless, there is an expressed reference to rate of return in § 1.167(l)-1(h)(6)(i). The operative rules for

normalizing timing differences relating to use of different methods and periods of depreciation are only logical in the context of rate of return regulation. The normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under § 168, is defined in terms of the method the taxpayer uses in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account. These are explicit elements of the definition of rate of return regulation contained in § 1.46-3(g)(2). Thus, it is clear that the definition of public utility property is the same for purposes of the investment tax credit and depreciation. It follows that if property is public utility property for purposes of the credit it is also public utility property for purposes of depreciation.

Thus, the key factors in determining whether property is public utility property are that (1) the property must be used predominantly in the trade or business of the furnishing or sale of, inter alia, electrical energy; (2) the rates for such furnishing or sale must be established or approved by a State or political subdivision thereof, any agency or instrumentality of the United States, or by a public service or public utility commission or similar body of any State or political subdivision thereof; and (3) the rates so established or approved must be determined on a rate-of-return basis. Here, Taxpayer will enter into a contract with Department for the entire output of Facility. The rates to be paid for the electricity under the contract will be determined in negotiations between the parties. Because the rates are determined solely by negotiations between a buyer (Department) and a seller (Taxpayer) rather than being established or approved by a governmental entity through a regulatory process on a rate of return basis, the rates are not “established or approved” within the meaning of former section 46(f), § 168(i)(10), and the regulations promulgated thereunder, notwithstanding that Department is a United States governmental agency. Therefore Facility is not public utility property within the meaning of those provisions.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. Specifically, no opinion is expressed concerning whether the contract to sell electricity constitutes a service contract under § 7701(e). In addition, no opinion is expressed concerning whether the Taxpayer is the owner of the Facility generating electricity for federal income tax purposes.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides 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. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: