Internal Revenue Service

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Washington, DC 20224

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Date:
March 02, 2017

In Re: Request on consequences under the normalization provisions

Legend:

Taxpayer =

State A =
State B =
Parent =

Operator =
Commission =
Year =
Authority =
Contract =

Company =
Director =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
a =
b =
c =
d =
e =

Dear :

This letter responds to the request, dated August 11, 2016, submitted on behalf of Taxpayer for a ruling on whether Taxpayer's Facility is not, in whole or in part, public utility property within the meaning of § 168(i)(10) of the Internal Revenue Code ("Code"). Depending on the outcome of this request, rulings are also requested on behalf of Taxpayer on the application of the depreciation normalization rules of § 168(i)(9) and § 1.167(l)-1 of the Federal Income Tax Regulations ("Regulations") (together, the "Normalization Rules") to certain State A regulatory procedures.

The representations set out in your letter follow.

Taxpayer is a limited liability company. All of Taxpayer's membership interests are owned by Parent, a State B corporation, directly or through disregarded entities. Taxpayer is a disregarded entity for federal income tax purposes and is, therefore, treated as a division of Parent. Parent is the common parent of a group of corporations that files a consolidated federal income tax return. The return is under the audit jurisdiction of the Large Business and International Division of the Internal Revenue Service. Taxpayer is an accrual basis taxpayer and reports on a calendar year basis.

Taxpayer owns and operates a peaking electric generating facility located in State A ("Facility"). Peaking units can rapidly produce electricity and, generally, are only used during periods of high demand or disruptions to the transmission system. They improve the reliability of the transmission system to which they are interconnected. The Facility is interconnected with Operator. As a wholesale power provider, under the Federal Power Act, Taxpayer is subject to the jurisdiction of Commission. To the extent Taxpayer's sales are under the jurisdiction of Commission, its rates are established through negotiation and/or by the wholesale market.

In Year, State A enacted legislation intended to encourage the planning for and construction of peaking electric generation plants located in State A in order to benefit State A electric consumers. Generally, the legislation required State A's electric distribution utilities and permitted any other person wanting to build peaking generation to submit its plan to the Authority between Date 1 and Date 2 for consideration. Any plan approved by Authority would include a requirement that the owner be compensated at its cost of service plus a reasonable rate of return on its prudently incurred investment. The level of compensation was to be established by Authority in annual contested rate cases with the return on equity reviewed at least every a years.

Under State A law, merchant generators (such as the Facility) are not electric distribution companies or any other type of public service company subject to regulation by Authority, and consequently, Authority does not have the statutory basis to subject

any such generator to cost of service regulation. However, Authority concluded in Year that merchant generators could agree contractually to submit to rate determinations. On Date 3, Taxpayer's predecessor in interest entered into a Contract with Company, a public service electric distribution company over which Authority exercises ratemaking jurisdiction. The provisions of the Contract describe the rules that govern the relationship between Taxpayer and Company.

Some of the pertinent provisions include:

1. Taxpayer agreed to construct, own, operate and maintain the Facility;
2. Taxpayer agreed that Authority will determine a revenue requirement, including a review of its cost of service, in annual contested proceedings. In these cases, the allowed return on equity will be indexed to an average of the returns approved for b unrelated State A electric distribution companies (rather than being based on a return on equity determination involving Taxpayer), plus c except that such return shall never go below d. In addition, limited portions of rate base and expense are reconciled to actual expenses in subsequent cases in a process known as a "True-Up";
3. Taxpayer agreed that, during the term of the Contract, any premium above book value received upon the sale of the Facility shall be paid to Company and returned to ratepayers. However, once the Contract term ends, ratepayers have no further claim and any proceeds from the sale of the Facility are solely for the Taxpayer's benefit.
4. The term of the Contract is e years.
5. Each year, Authority will establish a revenue requirement for Taxpayer based on the costs Taxpayer projects it will incur during the forthcoming contract year, a cost of equity as described in provision 2 above, and using certain other conventions. During that year, Taxpayer will receive monthly payments from Operator for capacity, power and ancillary services. Each month during the forthcoming contract year, Taxpayer computes the difference between 1/12 of the revenue requirement Authority established for Taxpayer and the amount of monthly payment Taxpayer received from the Operator. If the difference is positive, Company is obligated to make a payment to Taxpayer in the amount of the difference. If the amount is negative, Taxpayer is obligated to make a payment to Company in the amount of the difference. Outside of the Contract, Authority announced that any payments made by Company (and companies similarly situated) pursuant to the Contract will be recoverable by it from its ratepayers. Any Contract payments received by Company (and companies similarly situated) will be credited to its ratepayers.

The following ruling is requested on behalf of Taxpayer:

Taxpayer's Facility is not, in whole or in part, public utility property within the meaning of § 168(i)(10) of the Code.[1]

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) of the Code, 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) of the Regulations 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) of the Code are essentially identical. Section 1.167(l)-1(b) of the Regulations 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.

[1] Other rulings were requested on behalf of Taxpayer in the event that the Service reached an adverse conclusion to that requested by Taxpayer. Because, as set forth below, we have reached a favorable conclusion, the other rulings are moot and will not be discussed in this letter.

The regulations under former section § 46 of the Code, specifically § 1.46-3(g)(2) of the Regulations, 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 § 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. Thus, it is clear that, for purposes of application of the normalization rules, the definition of public utility property is the same for purposes of the investment tax credit and 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.

The Facility is used primarily in the trade or business of furnishing electrical energy, satisfying the first factor. The determination of amounts to be received by Taxpayer under the Contract, while containing some elements in common with the determination of rates for the furnishing or sale of electrical energy established or approved by a State or political subdivision thereof, such rates being determined on a rate-of-return basis, does not, under these facts, satisfy the second and third factor. Accordingly, we rule as follows:

Taxpayer's Facility is not public utility property within the meaning of § 168(i)(10) of the Code. Because we rule that the Facility is not public utility property, Taxpayer's additional ruling requests are moot and will not be addressed.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

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,

Patrick S. Kirwan
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)