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KPMG report: Property owned by tax equity partnership is not public utility property (PLR)

The IRS in a private letter ruling* addressed two issues posed by a public utility company seeking to develop a wind project using a tax equity partnership structure. PLR 201946007 (release date November 15, 2019; dated August 8, 2019).

In the ruling letter, the IRS determined that a new wind generation facility in a tax equity partnership structure would not be considered public utility property under section 168(i)(10) for purposes of determining whether the depreciation deductions from the facility would be subject to normalization rules. This determination was based on the fact that rates for the sale of electricity generated by the facility were expected to be determined on a market basis and not on a rate-of-return basis or cost basis. In the same letter ruling, the IRS declined, however, to rule on a second issue raised by the taxpayer as to whether certain losses allocated to the tax equity investor may be disallowed by related-party loss limitation rules under section 707(b).

Read the private letter ruling: **PLR 201946007** [PDF 62.2 KB]

*Private letter rulings are taxpayer-specific rulings furnished by the IRS National Office in response to requests made by taxpayers and can only be relied upon by the taxpayer to whom issued. It is important to note that, pursuant to section 6110(k)(3), such items cannot be used or cited as precedent. Nonetheless, such rulings can provide useful information about how the IRS may view certain issues.

Background

The taxpayer, a corporation, is the parent company and sole owner of Company, a limited liability company (LLC) that is disregarded for U.S. federal income tax purposes (collectively, the "Company"). Company and an independent investor ("Tax Equity Investor") formed a joint venture ("Wind JV") to develop a wind power facility ("Facility"). Profits, losses, and production tax credits are to be allocated to Company and Tax Equity Investor in accordance with Wind JV's operating agreement.

Wind JV planned to use the Facility to generate electricity to sell to Company under a wholesale power purchase agreement ("PPA"). The structure of Wind JV and related transactions, as well as the PPA, are subject to approval by a regulatory commission. The PPA states that the rate prices are to be

determined on a market basis, using a competitive bidding process, and not on a rate-of-return basis or cost basis.

Company planned to include the electricity purchased from Wind JV under the PPA as part of its system power to provide electric service to Company's retail customers. Company's sale of electricity to its retail customers will be subject to regulation by a commission.

After the date the Facility is completed, Company will have an option to purchase all of Tax Equity Investor's interests in Wind JV for fair market value in accordance with the terms of the LLC agreement.

In filing for the PLR, the taxpayer specifically requested that the IRS rule that:

- The Facility is not public utility property (or "PUP") under section 168(i)(10).
- Any losses of Wind JV allocated to Tax Equity Investor will not be disallowed under section 707(b).

PLR conclusion - public utility property

The IRS analyzed the rules for determining whether property can be characterized as PUP and concluded that there are three characteristics—all of which a facility must possess in order to be characterized as PUP:

1. It must be predominately used in the trade or business of the furnishing or sale of electric energy;
2. The rates for such sale must be established or approved by one of the enumerated agencies or instrumentalities; and
3. The rates set by that agency or instrumentality must be established or approved on a rate-of-return basis.

In the ruling, the IRS analyzed the factors at the partnership level and concluded that while the Facility will be predominantly used in the trade or business of the furnishing or sale of electric energy and will be subject to the jurisdiction of a commission—and thus possesses the first two characteristics of PUP—the Facility failed to meet the third characteristic to be considered PUP. For property to be PUP, the electricity generated must be sold at rates that are regulated by a government agency or public utility commission on a rate-of-return basis. Rates for the sale by Wind JV of electricity generated by the Facility are determined on a market basis. Therefore, the IRS determined that the Facility is not PUP.

KPMG observation

Tax equity deals for renewable energy projects are becoming more and more common for private energy developers looking to take advantage of credits to reduce their tax liability.* This PLR is viewed by tax professionals as being significant because previously there has been some uncertainty as to whether a tax equity investor could enjoy the full benefit of accelerated depreciation from an investment partnership with a regulated utility due to the possible application of the tax normalization rules.

*See Rev. Proc. 2007-65, 2007-45 IRB, which establishes a safe harbor for structuring the allocations of tax benefits by partnerships using wind to generate electricity.

PLR conclusion – related-party losses

While the IRS determined that the Facility was not PUP, the IRS declined to comment on the second request, that any losses of Wind JV allocated to Tax Equity Investor will not be disallowed under section 707(b). In declining to comment on this section, the IRS cited Section 6.09 of Rev. Proc. 2019-1, 2019-1 I.R.B. 1, which generally provides that the IRS will not issue a letter ruling or a determination

letter if the request presents an issue that cannot be readily resolved before a regulation or any other published guidance is issued.

KPMG observation

While the IRS declined to address the taxpayer's loss limitation concern under section 707(b), the question is still looming for many in the industry. Many taxpayers are looking to effectuate structural options to alleviate similar concerns. These options have included, but are not limited to, open market sales, hedging transactions, and tailored use of new bonus depreciation rules. Each taxpayer may have a different economic footprint and operate in unique markets. Such elements have important implications for public utility companies seeking to develop renewable projects using the tax equity structure, and thus, taxpayers needs to consider how to tailor their solutions appropriately.

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