KPMG

TaxNewsFlash

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

The IRS in a private letter ruling[1] reaffirmed its position in PLR 201946007[2] on two issues posed by a public utility company seeking to develop a wind project using a tax equity partnership structure.

PLR 202020011 [PDF. 89.9 KB] (release date May 15, 2020; dated February 13, 2020).

In the 2020 ruling, the IRS reaffirmed 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. In the same letter ruling, the IRS again 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).

Background

Parent, a corporation, is the parent company of a group of corporations that files a consolidated U.S. federal income tax return.

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[1] 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.

[2] See KPMG's *TaxNewsFlash*, which discussed PLR 201946007 wherein the IRS addressed issues similar to those proposed by the instant PLR.

Taxpayer, a corporation, is wholly owned by Parent. Taxpayer and an independent investor ("Investor") formed a joint venture ("LLC") to develop a wind power facility ("Facility"). Profits, losses, and production tax credits are to be allocated to Taxpayer and Investor in accordance with LLC's operating agreement.

LLC planned to use the Facility to generate electricity to sell to Taxpayer under a wholesale power purchase agreement ("PPA"). The structure of LLC and related transactions, as well as the PPA, are subject to approval by a regulatory commission. Prices under the PPA are determined on an arm's length, market basis pursuant to market-based rate authority of a regulatory commission, and not on a rate-of-return basis or cost basis.

Taxpayer planned to immediately sell all of the electricity purchased from LLC under the PPA into the wholesale electric market. Concurrently, Taxpayer planned to purchase electricity from the wholesale electric market to service its retail customers. Company's sale of electricity to its retail customers will be subject to regulation by a commission. This cost will be passed directly to Company's customers without additional markup through a rate adjustment mechanism.

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 LLC allocated to Investor or Taxpayer resulting from the sale of electricity by LLC to Taxpayer under the PPA 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 used predominately in the trade or business of the furnishing or sale of, inter alia, electric 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.

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 LLC 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.[3] The 2020 letter

[3] 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.

ruling, which aligns with PLR 201946007, is 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.

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 LLC allocated to Investor or Taxpayer will not be disallowed under section 707(b). In declining to comment on this section, the IRS cited Section 6.09 of Rev. Proc. 2020-1, 2020-1 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

This PLR marks another occasion through which the IRS has declined to address loss limitation concerns under section 707(b) for public utility companies considering the tax equity structure. This also marks another occasion in a private letter ruling when a public utility seemingly preferred owning the renewable generation facility over entering into a PPA with an independent generator to meet its servicing needs or satisfy regulatory renewable requirements.

If this trend continues, these letter ruling requests may become more frequent until more formal guidance is issued. Until that time, many taxpayers may consider utilizing structural options to navigate these concerns. Such avenues may include open market sales, the use of "synthetic PPAs" (or hedging transitions) to avoid direct sales to a partner, and the 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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