STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: PETITION OF WIND ENERGY)
DEVELOPMENT, LLC AND ACP LAND, LLC)
RELATING TO INTERCONNECTION)

WIND ENERGY DEVELOPMENT, LLC
AND ACP LAND, LLCs'
BRIEF

Wind Energy Development, LLC (WED) and ACP Land, LLC (ACP) (collectively Petitioners) hereby respond to the briefing issues set in the Commission's procedural memo of August 14, 2014.

I. Does the PUC have jurisdiction to determine the reasonableness of the pass through interconnection taxes charged by National Grid to Petitioners?

Yes, the Commission clearly has jurisdiction to determine whether the pass through interconnection tax is a reasonable charge. The Commission has a statutory mandate to fully investigate and resolve Petitioners' complaint about the reasonableness of this tax that was and is charged to them.

The Commission's enabling legislation clearly establishes that the legislature expects the Commission to address this issue. It states that the business of distributing electrical energy is "affected with a public interest" and that lower electrical rates promote our economy and general welfare, that the price of energy in Rhode Island create hardships in our state and that it is necessary for Rhode Island to achieve reasonable, stable rates, and system reliability that includes energy resource diversification and distributed generation. R.I. Gen Laws §39-1-1(a)(1), (d)-(e). It declares that "[s]upervision and reasonable regulation by the state of the manner in which such businesses . . .carry on their operations within the state are necessary to protect and promote the convenience, health, comfort, safety, accommodation, and welfare of the people, and are a proper exercise of the police power of the state." R.I. Gen Laws §§39-1-1(a)(1)-(2). With these purposes and declarations in mind, the legislature "vested in the public utilities commission and the division of public utilities and carriers the exclusive power and authority to supervise, regulate, and make orders governing the conduct of companies offering to the public in intrastate commerce energy, communication, and transportation services and water supplies for the purpose of increasing and maintaining the efficiency of the companies, according desirable safeguards and convenience to their employees and to the public, and protecting them and the public against improper and unreasonable rates, tolls and charges by providing full, fair, and adequate administrative procedures and remedies. . ." Id. at §39-1-1(c). The Commission's enabling legislation is to be "interpreted and construed liberally in aid of its declared purpose" and the Commission is given, "in addition to powers specified in this chapter, all additional, implied, and incidental power which may be proper or necessary to effectuate their purposes." Id. at §39-1-38.

Beyond the general expectation that the Commission will resolve such concerns, the legislature authorized the Commission to "serve as a quasi-judicial tribunal with jurisdiction, powers, and duties to implement and enforce the standards of conduct under § 39-1-27.6 and to hold investigations and hearings involving the rates, tariffs, tolls, and charges. . ." R.I. Gen Laws §31-9-3. It is the Commission's duty to "render[] independent decisions affecting the public interest and private rights based upon the law and upon the evidence presented before it by the division and by the parties in interest." R.I. Gen Laws §31-9-11.

This question about the reasonableness of National Grid's pass through tax is clearly and properly put before the Commission. Petitioners' concerns about National Grid's refusal to acknowledge and apply the IRS safe-harbor from the interconnection tax falls squarely within the legislature's expected role for the Commission, to safeguard Rhode Island's energy supply by protecting customers from improper and unreasonable rates and charges, and most certainly invoke the Commission's implied and incidental powers. In addition to the direct and obvious impact this charge has on those seeking to interconnect important new energy resources for Rhode Island, it also has a direct impact on ratepayers by increasing the cost of their electricity. The indirect impact is clear from the Distributed Generation Standard Contract Program that Petitioners participated in. The program sets the rates National Grid must pay for electricity generated from enrolled projects according to the development cost for these projects, including the cost of interconnection. The development/interconnection costs (and, therefore, the rates) can and presumably will be reduced if it is resolved that the interconnection tax is not owed by project developers. Likewise, in any net metering project developed under a public private partnership arrangement, economic sustainability requires the private developer to recover its cost of development through the rates charged to the public entity. Therefore, as interconnection/development costs come down, the private developer can and will pass that benefit through to the public entity in a lower rate.

National Grid proposed its interconnection tariff to the Commission for approval pursuant to its authority. Section 5.3 of the Interconnection Tariff proposes to provide a copy of the Company's policies regarding the collection of "tax gross ups" with each Impact Study.[1] The Commission evidently never reviewed or approved this tax gross up policy to ensure it is not an "unreasonable rate, toll or charge" per R.I. Gen Laws §39-1-1(c). The Commission must review and approve the distribution company's justification for the tax to comply with its statutory mandate and jurisdictional role over the tariff. In the absence of such review and approval, it is all the more important for the

[1] The Impact Studuy merely states as follows "The associated tax effect liability is the result of an IRS rule, which states that all costs for construction collected by National Grid, as well as the value of donated property, are considered taxable income." However, the IRS Rule is to exempt these projects from the tax as fully addressed in IRS Notice 88-129 and this proceeding.

PUC to give the customers affected by the tax "adequate administrative procedures and remedies" per R.I. Gen Laws §39-1-1(c).

Moreover, if there was any doubt about the Commission's expansive jurisdiction and affirmative mandate to resolve this question, section 9 of National Grid's own tariff invokes PUC jurisdiction over any disputes related to the tariff. Specifically, section 9.3 states that any party that does not accept the mediator's recommendation may request the Commission's adjudication, and that is precisely what has happened here. The parties elected to mediate this matter before PUC counsel, neither party accepted the recommendation on this specific issue, and both requested adjudication before the Commission to resolve it. Therefore, even if the Commission's legislatively granted jurisdiction over these matters were not plenary, National Grid has submitted to the Commission's jurisdiction by the terms of its own tariff and by asking that the Commission resolve this dispute.

National Grid apparently argues that the Internal Revenue Service has exclusive jurisdiction over a determination of whether this tax is owed or reasonably assessed to its interconnecting customers. First, that is clearly not the case when the IRS has already resolved the pending question definitively by issuing its Notice 88-129 and also precluded the possibility of National Grid's position that the safe-harbor only applies to transmission interconnections by issuing at least two Private Letter Rulings (including one to National Grid) that apply the safe-harbor to distribution interconnections. PLR 200403084 (National Grid's ruling) and PLR 201122005. National Grid's argument that Petitioners' cannot rely on private letter rulings for a legal conclusion ignores precedent acknowledging that PLRs do evidence the proper interpretation of tax law. Estate of Reddert v. United States, 925 F.Supp. 261, 267–68 (D.N.J.1996) (private letter rulings can serve as evidence of proper interpretation of statute); Woods Investment Co. v. Commissioner, 85 T.C. 274, 284 n. 15, 1985 WL 15380 (1985) (noting that private letter rulings reveal Commissioner's interpretation of tax law); Rowan Cos. v. United States, 452 U.S. 247, 261–62 n. 16, 101 S.Ct. 2288, 2296–97 n. 16, 68 L.Ed.2d 814 (1981) (I.R.C. §6110(j)(3) prohibits citation of private ruling as precedent, but private letter ruling shows IRS' view inconsistent with Treasury Regulation and ruling). Petitioners ask the Commission to fulfill its legislative mandate by applying the IRS Notice and precedent to protect National Grid's customers from unreasonable rates and charges.

Even if this question had not already been resolved by the IRS, it is National Grid's obligation to prove the reasonableness of this charged tax before assessing it to interconnecting generators. National Grid has no right to pass a tax through if the Commission has not definitively determined that the tax is owed and approved assessment of the tax. If the Commission feels there is insufficient clarity to rule on this tax question in response to this petition, then National Grid should be required to seek the refund of taxes already paid and should be prohibited from charging the tax until it demonstrates that the tax is clearly owed.

Although National Grid positions itself as the taxpayer for the purposes of this dispute, National Grid's interconnecting customers actually pay this tax. The interconnecting Petitioners have the right to seek relief from the tax through the means they deem most appropriate and effective. Their Petition gives the Commission the authority and the burden to ensure that National Grid's charge is reasonable and issue the remedy and relief that is appropriate.

II. Does the PUC have jurisdiction to determine whether Petitioners are liable for payment of taxes related to their interconnection projects?

Yes, as stated above, the Commission clearly has jurisdiction to determine whether the tax National Grid assesses to its customers is owed and, therefore, "reasonable." Indeed, the Commission must affirmatively determine whether the Petitioners are liable for payment of the disputed taxes related to their interconnection in order to determine whether National Grid's rates and charges are unreasonable. The mediator's recommendation in this matter was entirely correct in noting that, in the first instance, National Grid has the burden of proving that its rates and charges are reasonable pursuant to RI Gen Laws 39-3-12. (see page 6 – "The burden of proof of the reasonableness of a rate, toll or charge is unequivocally on the utility.") National Grid failed to meet its burden in its tariff proposal. The Commission should not have approved the tariff without a clear indication of why the tax was owed - it should not have allowed National Grid to justify the tax through a conclusory (and conclusively false) statement to its customers that is only provided in its Impact Studies and not in the tariff. This is not just a question of jurisdiction but an issue of whether the Commission will fulfill its statutory mandate to reject unreasonable rates and charges.

> *III. Does the PUC have the authority to require either the Petitioners or National Grid to seek a private letter ruling (PLR) from the IRS to determine whether taxes are owed by the Petitioners related to their interconnection projects? If so, does the PUC have the authority to determine whether the costs associated with seeking the PLR should be borne by either party?*

Given the statutory burden placed on National Grid to justify the reasonableness of its rates and charges and National Grid's failure to meet that burden when it filed its interconnection tariff, the Commission clearly has the authority to order National Grid to justify the tax, paying for any process necessary to conclusively reach such justification. Indeed, the Commission can only fulfill its statutory mandate by requiring National Grid to produce such definitive justification.

However, it is not necessary, nor is it a good expenditure of resources, to obtain a private letter ruling for more clarity on this issue. The only reasoning National Grid has provided for charging the tax despite the IRS safe-harbor is that IRS Notice 88-129 only applies to transmission interconnections and not distribution interconnections. National Grid's Response to Summary and Recommendations, p. 2 ("IRS Notice 88-129 and later notices to which Petitioners refer only provide a "safe harbor" for transmission interconnections and not for distribution interconnections, as is the case here"). National Grid cannot support that position in light of the plain language of Notice 88-

129 and especially when, according to its response to Commission Data Request 1-7, it sought a Private Letter Ruling on a distribution interconnection in Massachusetts and the resulting PLR was clear that the CIAC tax was not owed on the distribution interconnection. The IRS Notice defines “intertie” as follows:

> PURPA and its implementing rules and regulations require that a utility interconnect with a Qualifying Facility for the purposes of allowing the sale of power produced by the Qualifying Facility. A Qualifying Facility must bear the cost of the purchase and installation of any equipment required for the interconnection. This equipment, referred to herein as an "intertie," <u>may include new connecting and transmission facilities</u> [emphasis added], or modifications, upgrades or relocations of a utility's existing transmission network.

The notice clearly and simply applies to any qualifying facility’s equipment required for interconnection. On May 16, 2000, the US Department of Treasury responded to this inquiry about the application of IRS Notice 88-129 to interconnection applications from Qualifying Facilities (attached) as follows:

> The Notice provides a safe harbor, excluding from the definition of a CIAC certain transfers of interconnection facilities to utilities by Qualifying Facilities. The rationale for the safe harbor is that a Qualifying Facility is not a customer that receives services from the transferee utility under section 118(b) if the transfer of the interconnection facilities is to allow the producer to sell power to its customer utility. Since the Qualified Facility does not receive services from the transferee utility, there is no concern that the property transferred might be a form of prepayment for future services from the transferee. Accordingly, the transfer of the interconnection facilities is not a taxable CIAC to the transferee utility.

A note from the Energy Law Journal further explains:

> In IRS Notice 88-129, the IRS separated the tax treatment of interconnections from the long history of contributions in aid of construction. Contributions in aid of construction were paid to a utility by a customer in order to help the utility sell service to that customer. These payments were of a different nature than interconnection payments. PURPAS QFs typically sell power to utilities rather than buy power from utilities. Payments by qualifying facilities for interties, therefore, are generally not contributions in aid of construction, even if the intertie is used to wheel power to other utility customers of the QF. . .the IRS instituted a de facto di minimis test in which the utility could not receive an interconnection tax free and sell power to the QF of more than 5% of the total power flowing over the connection in the first ten taxable years, beginning with the year the property is placed in service.

Jackie S. Levinson and Andrew D. Schifrin, The Regulatory and Tax Treatment of Electric Interconnection Facilities," ENERGY LAW JOURNAL Vo. 23, No. 2 (2002), p. 486 (excerpt attached). IRS Notice 2001-82 expressly expanded the application of Notice 88-129, designed to safe-harbor interconnections for energy sales to the utility, to also safe-harbor interconnections that allow the Qualifying Facility to use the utility's transmission lines to wheel power to its other customers.

Moreover, IRS private letter rulings apply the safe-harbor in the context of interconnections to the distribution grid. PLR 1122005 ("Generator requests that Taxpayer interconnect Facility to Taxpayer's distribution system"), PLR 200403084 ("Generator signed an interconnection agreement with Taxpayer that provides for the interconnection of Project with Taxpayer's grid"). As set out above, these PLRs can be relied on as evidence of proper interpretation of the safeharbor in IRS Notice 88-129 and there can be no question that if the safe harbor only applied to transmission interconnections, as a matter of law, it could and would not have been applied to distribution interconnections in PLR 200403084 (National Grid's ruling) or PLR 201122005.

> *IV. If the actual cost of an impact study exceeds the statutory cap for a commercial project, must National Grid provide a final accounting of those excess costs when it bills them to the interconnecting customer?*

Yes, RI Gen Laws §39-26.3-4(c) requires an accounting of the actual costs of the study. That statute provides a fixed cost for Impact Studies with the exception that National Grid can increase the amount charged for impact studies on non residential projects based on "<u>actual costs</u>" incurred for the study as assessed after project completion. Section 5.1 of National Grid's Tariff confirms that "[t]he Interconnecting Customer shall be responsible for the <u>reasonably incurred costs</u> of the review by the Company and any interconnection studies conducted. . ." (emphasis added) There is no way for

National Grid or the customer to be sure of the actual cost incurred for the study, as assessed after project completion, without National Grid’s final account of such cost.

V. Must National Grid perform a final accounting of its actual interconnection costs and refund any excess estimated interconnection costs upon project completion?

National Grid is not entitled to charge more than its actual cost of conducting interconnections and must, therefore, produce audits reflecting the actual cost and automatically refund any difference between the prepaid, estimated interconnection cost and the actual cost of interconnection. The Tariff requires an interconnecting customer to pay all System Modification costs (Sheets 9, 24, Sheet 39 ¶¶5.3 -5.4) at "reasonable" "actual costs." Moreover, Section 5.4 states:

> Should the Company combine the installation of System Modifications with additions to the Company's EPS to serve other customers or interconnecting customers, the Company shall not include the costs of such separate or incremental facilities in the amounts billed to the Interconnecting Customer for the System Modifications required pursuant to thisInterconnection Tariff.
>
> The Interconnecting Customer shall only pay for that portion of the interconnection costs resulting solely from the System Modifications required to allow for safe, reliable parallel operation of the Facility with the Company EPS.The interconnection costs are first estimated in the feasibility study and then refined in the impact study.

The final estimated costs must be paid before the interconnection work will be done. In the absence of an audit upon completion, the customer has no way to determine whether the paid costs are "actual" or "reasonable" as required by the tariff, or whether they include additions to the Company's Electric Power System to serve other customers.

National Grid's interconnection agreement requires that the customer request, within a specified time, a final accounting of interconnection ("system modification") costs before National Grid has an obligation to refund any estimated and prepaid costs that exceed the actual costs of the studies and System Modifications. Tarriff at Sheet 67 ¶7, Sheet 71 ¶7, Sheet 74 ¶5.2. This requirement of the agreement is inconsistent with the Tariff's requirement that National Grid charge no more than its reasonable, actual cost of system modifications necessary to achieve that specific project's interconnection. This provision also only enables National Grid to recover costs exceeding its estimate upon the customer's request for an audit, leading both to National Grid's inclination toward conservative estimating and deterrent risk for customers requesting audits. The audit and refund must be standard and automatic practice.

National Grid takes the position that its form of interconnection agreement was approved with the Tariff and that its requirement of an audit request for the refund of any overcharge is authorized by the Commission unless and until the Commission revises the Tariff. However, section 20 of the Interconnection Agreement makes it clear that "[i]n the event of a conflict between this Agreement, the Interconnection Tariff, or the terms of any other tariff, Exhibit or Attachment incorporated by reference, the terms of the Interconnection Tariff, as the same may be amended from time to time, shall control." The language of the Tariff clearly conflicts with the audit request requirement in National Grid's form of Interconnection Agreement. Sound public policy does not support a result that enables National Grid to keep overcharges generated by its conservative cost estimating.

Thus far, National Grid has produced two audits regarding the actual costs of the interconnection work on Petitioner's project as compared to the estimated cost paid by Petitioners before the interconnection. In those audits it was determined that ACP Land, LLC's estimated payment of $91,531 was $59,154.99 higher than the actual cost of conducting its interconnection and that WED NK Green, LLC's estimated payment of $169,767 was $47,855.18 higher than the actual cost of conducting its interconnection. It is very clear from these results that the Commission can only fulfill its role of protecting customers and rates by requiring National Grid to account for its actual costs after completing its interconnections.

VI. Should National Grid perform an automatic final accounting when interconnection costs exceed $5,000?

As stated in Section IV above, Petitioners submit that National Grid must perform a final accounting of impact study costs whenever the actual costs of conducting an impact study for a commercial customer exceed the statutory minimum of $10,000. As further stated in Section V above, Petitioners submit that National Grid must provide a final accounting for all of its interconnection work, whether it exceeds $5,000 or not, to ensure that its estimated of the interconnection costs that must be prepaid by the interconnecting customer does not exceed the actual cost of conducting the interconnection.

WIND ENERGY DEVELOPMENT, LLC, & ACP LAND, LLC

By their attorneys,

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CERTIFICATE OF SERVICE

I hereby certify that on August 29, 2014, I delivered a true copy of the foregoing document to National Grid by electronic mail.

Seth H. Handy

FTC

Notice 88-129, 1988-2 CB 541, IRC Sec(s). 118

Headnote:

Notice 88-129, 1988-2 CB 541[CAUTION: This Notice has been amplified and modified by Notice 90-60, 1990-2 CB 345 and Notice 2001-82, 2001-2 CB 619.]

Reference(s): Code Sec. 118;

Full Text:

Transfers of Property to Regulated Public Utilities by "Qualifying Facilities."

This notice provides guidance with respect to certain payments or transfers of property to regulated public utilities ("utilities") by qualifying small power producers and qualifying cogenerators (collectively "Qualifying Facilities"), as defined in section 3 of the Federal Power Act, as amended by section 201 of the Public Utilities Regulatory Policies Act of 1978 ("PURPA").

BACKGROUND

Notice 87-82, 1987-2 C.B. 389, addressed the Federal tax treatment of contributions in aid of construction ("CIACS") in light of the amendments made to section 118 of the Internal Revenue Code ("Code") by section 824 of the Tax Reform Act of 1986 (the "1986 Act"). Notice 87-82 reserved for separate guidance the treatment of payments or transfers of property made by Qualifying Facilities to utilities in connection with sales of power under PURPA. The Internal Revenue Service has received many inquiries concerning whether, as a result of the 1986 Act, such transfers result in income to utilities. This notice provides guidance with respect to certain types of transfers from Qualifying Facilities to utilities. No inference is intended with respect to other types of transfers.

1. Transfers Exclusively in Connection With the Sale of Electricity by a Qualifying Facility.

PURPA and its implementing rules and regulations require that a utility interconnect with a Qualifying Facility for the purpose of allowing the sale of power produced by the Qualifying Facility. A Qualifying Facility must bear the cost of the purchase and installation of any equipment required for the interconnection. This equipment, referred to herein as an "intertie," may include new connecting and transmission facilities, or modifications, upgrades or relocations of a utility's existing transmission network. Generally, the utility takes legal title to the intertie, which becomes part of the utility's transmission network. Under standard cost-based rate regulation, utilities may neither earn a profit on sales of power purchased from Qualifying Facilities nor include the cost of interties in rate base.**<Page 542>**

The amendment of Code section 118(b) by the 1986 Act was intended to require utilities to include in income the value of any contribution in aid of construction made to encourage the provision of services by a utility to a customer. See H.R. Rep. No. 841, 99th Cong., 2d Sess. 324 (1986) (Conference Report). In a CIAC transaction the purpose of the contribution of property to the utility is to facilitate the sale of power by the utility to a customer. In contrast, the purpose of the contribution by a Qualifying Facility to a utility is to permit the sale of power by the Qualifying Facility to the utility. Accordingly, the fact that the 1986 amendments to Code section 118(b) render CIAC transactions taxable to the utility does not require a similar conclusion with respect to transfers from Qualifying Facilities to utilities.

Qualifying Facilities generally sell electricity to utilities pursuant to long-term power purchase contracts. Some contracts require the Qualifying Facility to construct and install the intertie, and subsequently transfer the intertie to the utility. With respect to transfers of property made by a Qualifying Facility to a utility exclusively in connection with the sale of electricity by the Qualifying Facility to the utility, a utility will not realize income upon transfer of an intertie by a Qualifying Facility. These nontaxable transfers are referred to herein as "QF transfers." The possibility that an intertie may be used to transmit power to a utility that will in turn transmit the power across its transmission network for sale by the Qualifying Facility to another utility (i.e., "wheeling") shall not cause the contribution to be treated as a CIAC. A utility takes no basis in property transferred in a QF transfer, thus, for example, a utility shall not be allowed any depreciation (or amortization) deductions with respect to the property transferred in a QF transfer.

Under some power purchase contracts, the utility agrees to construct and install the intertie on behalf of the Qualifying Facility, with the Qualifying Facility agreeing to reimburse or finance the construction and installation costs. A utility that constructs an intertie in exchange for a cash payment from a Qualifying Facility pursuant to a PURPA contract will be deemed to construct the property for the Qualifying Facility under contract and will recognize income from the construction in the same manner as any other taxpayer constructing similar property under contract. See, e.g., Code section 460. Subsequent to the construction of the property, the Qualifying Facility will be deemed to transfer the property to the utility in a QF transfer that will be treated in exactly the same manner as an in-kind QF transfer.

2. Other QF Transfers.

In some situations the transfer of property by a Qualifying Facility to a utility may not be exclusively in connection with the sale of power from the Qualifying Facility to the utility. In addition to transmitting power from the Qualifying Facility to the utility, the intertie may be used to transmit power from the utility for sale to the Qualifying Facility (a "dual-use intertie"). A dual-use intertie may be employed where a Qualifying Facility relies on the utility as a "backup" or supplemental power source, either sporadically or on a regular basis. The transfer of a dual-use intertie may be treated as a QF transfer, as provided in the following paragraph; however, the transfer of an asset necessary only for sale of power by the utility to the Qualifying Facility is not a QF transfer and constitutes a CIAC, even if the asset is used in part in connection with the transmission of power to the utility. Thus, for example, if at the time of a QF transfer a Qualifying Facility transfers an asset necessary only for the sale of power to the Qualifying Facility, the transfer of that asset is not a QF transfer.

The contribution of a dual-use intertie to a utility will be treated as a QF transfer (and, therefore, nontaxable) if, in light of all information available to the utility at the time of transfer, it is reasonably projected that during the first ten taxable years of the utility, beginning with the year in which the transferred property is placed in service, no more than 5% of the projected total power flows over the intertie will flow to the Qualifying Facility (the "5% test"). Such a projection shall, if practicable, be supported by a report from an independent engineer. Total power flows means power flows to or from the Qualifying Facility over the intertie. For purposes of this notice, power flows to a Qualifying Facility include power flows to a related party of the Qualifying Facility, if the transmission of power to the related party has been facilitated by the transfer of the intertie. Thus, for example, in the case of a modification or relocation of a utility's existing transmission line, power flows to an unrelated third party are ignored. For purposes of the 5% test, power flows in the taxable year in which the transferred property is placed in service may, at the option of the utility, be ignored. For example, suppose a utility and a Qualifying Facility enter into a power purchase contract with a term of twenty years, and power flow from the utility to the Qualifying Facility is expected to comprise 10% of total power flows in the first year (the taxable year in which the facility is placed in service), 1% in the second and third years, and 0.5% in each of the fourth through tenth years. Total power flows are projected to be 100 megawatt hours ("MWH") in the first and second years, and 200 MWH in the third through tenth years. Assume that the taxpayer excludes the first year of the contract from the projection. Thus, the taxpayer reasonably projects that power flow to the Qualifying Facility will be 0.59% of total power flows over the intertie for the applicable nine-year period ((1% X 100 MWH + 1% X 200 MWH + 7 X (0.5% X 200 MWH))/(100 MWH + 8 × 200 MWH)). Under the 5% test provided in this notice, the contribution of the intertie to the utility by the Qualifying Facility will be treated as a QF transfer and, therefore, shall be nontaxable.

3. Excluded Transfers.

Certain transfers that would otherwise qualify as QF transfers are excluded from the definition of QF transfers if such transfers are described in this section 3 of this notice. A transfer from a Qualifying Facility to a utility will not be treated as a QF transfer under this notice to the extent the intertie is included in the utility's rate base. Moreover, a transfer of an intertie to a utility will not be treated as a QF transfer under this notice if the term of the power purchase contract is less than ten years.

4. Termination of Safe Harbor.

The fact that a transfer constitutes a QF transfer under this notice does not establish that a utility will never recognize income attributable to receipt of the transferred property. The occurrence of an event specified below in section 4(A) or 4(B) shall terminate the safe harbor and require the utility to recognize income as a consequence of the QF transfer.

(A) *Proportionate Disqualification.* If, for each of any three taxable years within any period of five consecutive taxable years, more than 5% of the total power <Page 543> flows over the intertie flow from the utility to the Qualifying Facility (a "disqualification event"), then the Qualifying Facility will be deemed to have made a transfer to the utility which constitutes a CIAC under section 118(b) as of the last day of the third such year. At the option of the utility, the taxable year in which the property is placed in service shall not be taken into account in determining whether there has been a disqualification event. The amount of the CIAC shall be that percentage of the fair market value of the intertie as of the date of the deemed transfer which is reflective of the use of the intertie for the purpose of selling power to the Qualifying Facility, determined by the Internal Revenue Service by taking into account all facts and circumstances. Relevant factors include (1) the use of the intertie during the period immediately preceding the disqualification event; (2) the use of the intertie since the date it was placed in service; (3) the reasonably anticipated use of the intertie during the remaining term of the power purchase contract. See section III of Notice 87-82 for guidance as to the fair market value of a CIAC. For example, suppose a Qualifying Facility contributes an intertie to a utility that is a calendar year taxpayer. The utility places the intertie in service in 1990, and reasonably projects that over the ten taxable years beginning in 1990 power flows over the intertie to the Qualifying Facility will be less than 5% of total power flows over the intertie. Power flows over the intertie to the Qualifying Facility constitute the following percentages of total flows over the intertie: 10% in 1990; 7% in 1991; 6% in 1992; 3% in 1993; 1% in 1994; and 6% in 1995. The utility excludes 1990 (the year in which the intertie is placed in service) from the determination of whether a disqualification event has occurred. A disqualification event occurs due to power flows in 1995, the third year within the five year period from 1991 to 1995 in which more than 5% of power flows over the intertie flow to the Qualifying Facility. Therefore, the Qualifying Facility is deemed to have made a CIAC transfer to the utility as of December 31, 1995.

Proportionate disqualification does not apply to any property necessary for, and used solely to facilitate, the transmission of power by the Qualifying Facility to the utility. For example, suppose the contract between a Qualifying Facility and a utility requires the utility to relocate a major transmission line and to construct an intertie to the Qualifying Facility including protective devices which are necessary and used solely for the delivery of power to the utility. Several years into the contract, the use of the intertie by the utility for delivery of power results in a disqualification event. Payments made for the construction of the protective devices are not subject to proportionate disqualification, while payments made for the relocation of the transmission lines are subject to proportionate disqualification (because the transmission line is used for the delivery of power over the intertie by the utility to the Qualifying Facility).

(B) *Termination of Power Purchase Contract.* Upon the termination of the power purchase contract between a Qualifying Facility and a utility, if the utility obtains or retains ownership (for tax purposes) of property transferred in a QF transfer, the Qualified Facility will be deemed to have made a transfer to the utility which constitutes a CIAC under section 118(b) as of the first day of such termination. The amount of the CIAC shall be the fair market value of the intertie, less the amount, if any, paid by the utility to obtain or retain ownership of the property for tax purposes. Therefore, if the amount paid by the utility is fair market value, the Qualified Facility will not be deemed to have made a CIAC transfer. See Section III of Notice 87-82 for guidance as to the fair market value of a CIAC.

5. Notification Requirements.

If for any taxable year power flows to the Qualifying Facility exceed 5% of total power flows over the intertie, then the utility must attach a statement to this effect to its return for such taxable year. If a power supply contract subject to the provisions of this notice terminates, the utility must attach a statement to this effect to its return for the year in which the termination occurs. The notification requirements of this section 5 apply to taxable years ending more than 180 days after December 27, 1988, the date this notice is published in the Bulletin.

6. Cost Recovery of QF Transfer Property.

Sections 1.461-1(a)(1) and (2) of the Income Tax Regulations provide that taxpayers using the cash and accrual methods of accounting, respectively, may not currently deduct the total amount of an expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year. Instead, such taxpayers are required to capitalize such expenditures as assets and recover the cost of the expenditures over the useful life of the asset in question. See, e.g., Rev. Rul. 70-413, 1970-2 C.B. 103. The cost of property transferred in a QF transfer must be capitalized by the Qualified Facility as an intangible asset and recovered as appropriate. Cf. Section VII of Notice 87-82 (amortization of the cost of a CIAC by the contributor).

A utility may not take depreciation (or amortization) deductions with respect to property transferred in a QF transfer. This rule applies regardless of whether the Qualifying Facility initially transfers intertie property to the utility or whether the Qualifying Facility initially transfers cash followed by a deemed QF transfer to the utility. However, if property which is the subject of a QF transfer is subsequently transferred or deemed transferred to the utility as a CIAC, the utility may be allowed to take depreciation deductions with respect to the property.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or a revenue procedure.

IRS Letter Rulings and TAMs (1998-2012), UIL No. 0118.01-02 Contributions to the capital of a corporation; Contributions by shareholders; Nonshareholder contributions. UIL No. 0118.02-01 Contributions to the capital of a corporation; Contributions in aid of construction; Not included under subsection (a). UIL No. 0118.02-02 Contributions to the capital of a corporation; Contributions in aid of construction; Definition of contribution in aid of construction. IRS Letter Ruling 201122005 (Mar. 02, 2011), Internal Revenue Service, (Mar. 2, 2011)

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LTR 201122005, March 02, 2011

Symbol: CC:PSI:B05-PLR-137108-10

Uniform Issue List Nos. 0118.01-02, 0118.02-01, 0118.02-02

[Code Sec. 118]

Contributions to the capital of a corporation; Contributions by shareholders; Nonshareholder contributions; Contributions to the capital of a corporation; Contributions in aid of construction; Not included under subsection (a); Contributions to the capital of a corporation; Contributions in aid of construction; Definition of contribution in aid of construction.

This letter responds to your letter dated September 9, 2010, requesting a letter ruling concerning whether the transfer of an intertie from Generator to Taxpayer is a nonshareholder contribution to capital excludable from Taxpayer's income under § 118(a) of the Internal Revenue Code.

Taxpayer is a State 2 Corporation engaged in the business of generating, transmitting and distributing electrical energy to wholesale and retail customers predominantly in State 2. Taxpayer is a wholly-owned subsidiary of Corp 1, a State 2 corporation. Taxpayer and Corp 1 file a consolidated federal income tax return on a calendar year basis using the accrual method of accounting.

Generator, a State 1 limited liability company, will own, operate and maintain Facility located at Site. Generator submitted applications to Taxpayer for interconnection of Facility with the transmission and distribution system belonging to Taxpayer and Corp 2 (collectively the "Grid") at Substation 1.

On Date 1, Taxpayer filed Agreement 1, Agreement 2 and Agreement 3 (collectively, the "Agreements") between Taxpayer and Generator. Under the Agreements, Generator requests that Taxpayer interconnect Facility to Taxpayer's distribution system via a dedicated position at Substation 2. Taxpayer will engineer, design, procure, construct, install, own, operate, and maintain the facilities required to interconnect Facility to Taxpayer's distribution system (the "Interconnection Facilities"). Taxpayer also will engineer, design, procure construct, install, own, operate and maintain certain upgrades to its distribution system ("Distribution Upgrades"). Generator is responsible for the costs of those assets, which are estimated to be $c.

Agreement 3 specifies the terms and conditions under which Taxpayer will engineer, design, procure, construct, install, own, operate and maintain the ***** Facilities, and for Generator to pay for the ***** Facilities. The ***** Facilities are the facilities necessary to connect Facility's switchyard to the Interconnection Facilities at Substation 2 other than the Interconnection Facilities and the Distribution Upgrades. The cost of the ***** Facilities is estimated to be $d.

The Interconnection Facilities, the Distribution Upgrades, and the ***** Facilities, together are referred to as the "intertie."

Agreement 2 sets forth Taxpayer's agreement to provide distribution service for e Megawatts produced by Facility from Facility's interconnection at Substation 2 to the Grid at Substation 1. Agreement 2 terminates on the earliest of 1) f years from the commencement of distribution service under Agreement 2, or 2) the termination of Agreement 1. Agreement 1 has a term of f years and is automatically renewed for each successive g-year period.

Taxpayer will be the owner and sole operator of the intertie and the intertie will become a permanent part of Taxpayer's transmission and distribution system. Generator has entered into contracts and expects to enter into additional contracts with end users and power marketers to sell power from Facility. Taxpayer represents that the intertie will not be included in Taxpayer's rate base, and that Taxpayer will not take any depreciation deductions with respect to the intertie.

Generator represents: (1) Facility is a stand-alone generator as contemplated under Notice 2001-82; (2) The intertie will be used in connection with the transmission and distribution of electricity for sale to third parties; (3) Title to the electricity will pass to purchasers at the busbar on Facility's end of the intertie; (4) Generator will capitalize the contribution as an intangible asset and recovered using the straight-line method of accounting over a useful life of 20 years; and (5) Any portion of the intertie that is a dual use intertie within the meaning of Notice 88-129, 1988-2 C.B. 541, is reasonably expected to carry no more than a de minimis amount of electricity to Facility or to Generator or a related person (defined as no more than 5 percent of the projected power flows in both directions over the intertie during Generator's first 10 years after the intertie is placed in service).

Taxpayer requests a ruling that the contribution of cash for construction of the intertie by Generator to Taxpayer will not be considered a contribution in aid of construction under § 118(b) (CIAC), and will be excludable from Taxpayer's income as a non-shareholder contribution to capital under § 118(a).

Section 61(a) and § 1.61-1 of the Income Tax Regulations provide that gross income means all income from whatever source derived, unless excluded by law. Section 118(a) provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Section 118(b), as amended by § 824(a) of the Tax Reform Act of 1986 (the 1986 Act) and § 1613(a) of the Small Business Job Protection Act of 1996, provides that for purposes of subsection (a), except as provided in subsection (c), the term "contribution to the capital of taxpayer" does not include any CIAC or any other contribution as a customer or potential customer.

Section 1.118-1 of the Income Tax Regulations provides, in part, that § 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid to induce the taxpayer to limit production.

The legislative history to § 118 indicates that the exclusion from gross income for nonshareholder contributions to capital of a corporation was intended to apply to those contributions that are neither gifts, because the contributor expects to derive indirect benefits, nor payments for future services, because the anticipated future benefits are too intangible. The legislative history also indicates that the provision was intended to codify the existing law that had developed through administrative and court decisions on the subject. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18-19 (1954).

Notice 88-129, 1988-2 C.B. 541, as modified and amended by Notice 90-60, 1990-2 C.B. 345, and Notice 2001-82, 2001-2 C.B. 619, provides specific guidance with respect to the treatment of transfers of property to regulated public utilities by qualifying small power producers and qualifying cogenerators (collectively, Qualifying Facilities), as defined in section 3 of the Federal Power Act, as amended by section 201 of PURPA.

The amendment of § 118(b) by the 1986 Act was intended to require utilities to include in income the value of any CIACs made to encourage the provision of services by a utility to a customer. See H.R. Rep. No. 841, 99th Cong., 2d Sess. 324 (1986). In a CIAC transaction, the purpose of the contribution of property to the utility is to facilitate the sale of power by the utility to a customer. In contrast, the purpose of the contribution by a Qualifying Facility to a utility is to permit the sale of power by the Qualifying Facility to the utility. Accordingly, the fact that the 1986 amendments to § 118(b) render CIAC transactions taxable to the utility does not require a similar conclusion with respect to transfers from Qualifying Facilities to utilities.

Notice 88-129 provides that with respect to transfers made by a Qualifying Facility to a utility exclusively in connection with the sale of electricity by the Qualifying Facility to the utility, a utility will not realize income upon transfer of interconnection equipment (intertie) by a Qualifying Facility. The possibility that an intertie may be used to transmit power to a utility that will in turn transmit the power across its transmission network for sale by the Qualifying Facility to another utility (wheeling) will not cause the contribution to be treated as a CIAC.

Further, the notice provides that a transfer from a Qualifying Facility to a utility will not be treated as a Qualifying Facility transfer (QF transfer) under this notice to the extent the intertie is included in the utility's rate base. Moreover, a transfer of an intertie to a utility will not be treated as a QF transfer under this notice if the term of the power purchase contract is less than ten years.

The notice also provides that a utility that constructs an intertie in exchange for a cash payment from a Qualifying Facility pursuant to a PURPA contract will be deemed to construct the property under contract and will recognize income from the construction in the same manner as any other taxpayer constructing similar property under contract. Subsequent to the construction of the property, the Qualifying Facility will be deemed to transfer the property to the utility in a QF transfer that will be treated in exactly the same manner as an in-kind QF transfer.

Notice 2001-82 amplifies and modifies Notice 88-129. Notice 2001-82 extends the safe harbor provisions of Notice 88-129 to include transfers of interties from nonQualifying Facilities, and transfers of interties used exclusively or in part to transmit power over the utility's transmission grid for sale to consumers or intermediaries (wheeling). The notice requires that ownership of the electricity wheeled passes to the purchaser prior to its transmission on the utility's transmission grid. This ownership requirement is deemed satisfied if title passes at the busbar on the generator's end of the intertie. Further, Notice 2001-82 provides that a long-term interconnection agreement in lieu of a long-term power purchase contract may be used to satisfy the safe harbor provisions of Notice 88-129 in wheeling transactions. Finally, Notice 2001-82 requires that the generator must capitalize the cost of the property transferred as an intangible asset and recover such cost using the straight-line method over a useful life of 20 years.

In the instant case, the transfer of the intertie is subject to the guidance set forth in Notice 88-129, Notice 90-60, and Notice 2001-82 for the following reasons: (1) Facility is a stand-alone generator as contemplated under Notice 2001-82; (2) Generator and Taxpayer entered into a long-term interconnection agreement; (3) the intertie will be used in connection with the transmission of electricity for sale to third parties (wheeling); (4) the cost of the intertie paid by Generator will not be included in Taxpayer's rate base; (5) Taxpayer will not take any depreciation deductions with respect to the intertie; (6) based on all available information, the portion of the intertie that is a dual use intertie is reasonably expected to carry no more than 5 percent of the projected power flows in both directions over the intertie during the first 10 taxable years beginning in the year the intertie is placed in service; (7) ownership of the electricity produced by Facility that is wheeled will pass to the purchaser prior to its transmission on Taxpayer's transmission grid; and (8) the cost of the intertie will be capitalized by Generator as an intangible asset and recovered using the straight-line method over a useful life of 20 years. Thus, we conclude that the deemed contribution of the intertie by Generator to Taxpayer meets the safe harbor requirements of Notice 88-129, as amended and modified by Notice 90-60 and Notice 2001-82.

Next, we must decide whether the contribution qualifies as a contribution to capital under § 118(a).

The legislative history of § 118 provides, in part, as follows:

This [§ 118] in effect places in the Code the court decisions on the subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the treating the contribution as a payment for future services.

S. Rep. No. 1622, 83d Cong., 2d Sess. 18-19 (1954).

In Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943) [43-1 USTC ¶9418], the Court held that payments by prospective customers to an electric utility company to cover the cost of extending the utility's facilities to their homes, were part of the price of service rather than contributions to capital. The case concerned customers' payments to a utility company for the estimated cost of constructing service facilities (primary power lines) that the utility company otherwise was not obligated to provide. The customers intended no contribution to the company's capital.

Later, in Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950) [50-1 USTC ¶5958], 1950-1 C.B. 38, the Court held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned that when the motivation of the contributors is to benefit the community at large and the contributors do not anticipate any direct benefit from their contributions, the contributions are nonshareholder contributions to capital. Id. at 41.

Finally, in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 413 (1973) [73-1 USTC ¶9478], the Court, in determining whether a taxpayer was entitled to depreciate the cost of certain facilities that had been funded by the federal government, held that the governmental subsidies were not contributions to the taxpayer's capital. The court recognized that the holding in Detroit Edison Co. had been qualified by its decision in Brown Shoe Co. The Court in Chicago, Burlington & Quincy Railroad Co. found that the distinguishing characteristic between those two cases was the differing purpose motivating the respective transfers. In Brown Shoe Co., the only expectation of the contributors was that such contributions might prove advantageous to the community at large. Thus, in Brown Shoe Co., since the transfers were made with the purpose, not of receiving direct services or recompense, but only of obtaining advantage for the general community, the result was a contribution to capital.

The Court in Chicago, Burlington & Quincy Railroad Co. also stated that there were other characteristics of a nonshareholder contribution to capital implicit in Detroit Edison Co. and Brown Shoe Co. From these two cases, the Court distilled some of the characteristics of a nonshareholder contribution to capital under both the 1939 and 1954 Codes. First, the payment must become a permanent part of the transferee's working capital structure. Second, it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. Third, it must be bargained for. Fourth, the asset transferred foreseeably must benefit the transferee in an amount commensurate with its value. Fifth, the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

The transfer of the intertie by Generator to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the intertie will become a permanent part of Taxpayer's working capital structure. Second, the transfer is not compensation for services provided by for Generator by Taxpayer. Third, the transfer is a bargained-for exchange. Fourth, the transfer will foreseeably result in a benefit to Taxpayer commensurate with its value because the intertie will become part of Taxpayer's transmission system. Fifth, the intertie will be used by Taxpayer in its trade or business for producing gross income. Therefore, Taxpayer's receipt from Generator of the intertie will be a contribution to capital under § 118(a).

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer, we rule that the transfer of the intertie by Generator to Taxpayer will not be a CIAC under § 118(b) and will be excludable from the gross income of Taxpayer as a nonshareholder contribution to capital under § 118(a).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely, Nicole R. Cimino, Senior Technician Reviewer, Branch 5 (Passthroughs & Special Industries).

cc: *****

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

May 16, 2000

Number: **INFO 2000-0067**
Release Date: 6/30/2000
U.I.L.: 118.00-00

The Honorable Tom Bliley
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Bliley:

Commissioner Rossotti asked me to respond to the letter dated March 23, 2000, from you and Congressman Bill Archer. You asked the Internal Revenue Service (IRS) to quickly resolve the issue of whether interconnection facilities transferred to an electric utility by an independent power producer constitute a taxable "contribution in aid of construction" (CIAC) under section 118(b) of the Internal Revenue Code.

For a corporation, section 118(a) provides that gross income does not include any contribution to the capital of the taxpayer. Section 118(b) provides that the term "contribution to the capital of the taxpayer" does not include any CIAC or any other contribution as a customer or a potential customer, except for water and sewerage disposal utilities.

Notice 88-129 Addresses Interconnection Transfers by a Qualifying Facility to a Utility

Notice 88-129 provides guidance for certain transfers of property to regulated public utilities by qualifying small power producers and qualifying cogenerators (collectively, Qualifying Facilities), defined in section 3 of the Federal Power Act, amended by section 201 of the Public Utilities Regulatory Policies Act of 1978 (PURPA). PURPA requires an electric utility interconnect with a Qualifying Facility to allow the sale of power produced by the Qualifying Facility. A Qualifying Facility must bear the cost of the purchase and installation of equipment required for the interconnection. Generally, the utility takes legal title to the interconnection facilities, which become part of the utility's transmission network. The Notice addresses whether interconnection facilities transferred by a Qualifying Facility to a utility constitute a section 118(b) CIAC to the transferee utility.

The Notice provides a safe harbor, excluding from the definition of a CIAC certain transfers of interconnection facilities to utilities by Qualifying Facilities. The rationale for the safe harbor is that a Qualifying Facility is not a customer that receives services from the transferee utility under section 118(b) if the transfer of the interconnection facilities is to allow the producer to sell power to its customer utility. Since the Qualified Facility does not receive services from the transferee utility, there is no concern that the property transferred might be a form of prepayment for future services from the transferee. Accordingly, the transfer of the interconnection facilities is not a taxable CIAC to the transferee utility. In past private letter rulings, the IRS has interpreted the safe harbor to apply to similar transfers by producing facilities that were not PURPA Qualifying Facilities.

The IRS Is Deciding Whether to Extend Notice 88-129 for Third Party Sales

The inquiry you and others have recently made raises the question of whether the safe harbor should be extended when the interconnection is transferred to a utility, not to sell power to the utility, but rather, to transport the power over the utility's transmission network for sales to third parties.

Your Transaction Differs from the Notice Transaction

The transaction you describe is materially different from the transaction in the Notice. The transaction in the Notice arises in a regulated marketplace where the Qualifying Facility's power is sold under a long-term power purchase agreement to the transferee utility. The transaction you describe arises in a deregulated marketplace where the producer's power is not sold to the utility but is transported over the utility's transmission lines into a "power pool" where third-party buyers bid on the producer's power.

The IRS and the Treasury Department are considering the proper tax treatment for this type of transaction. Among the issues to be resolved is whether the transferor producer's use of the transferee utility's transmission lines makes the transferor a customer receiving transportation services for purposes of section 118(b).

Constituents Should Forward Comments to the IRS

We encourage your constituents, as well as interested members of the electric power industry, to forward their views regarding this type of transaction to the attention of Gregory N. Doran, Attorney-Advisor (CC:DOM:P&SI:5), in the Office of Chief Counsel, IRS.

I have sent a similar letter to Congressman Archer. I hope the information provided is helpful. Please contact me at (202) 622-4500 if I can be of further assistance; or have a member of your staff contact Gregory Doran, at (202) 622-3153.

Sincerely,

Judith C. Dunn (signed)

Judith C. Dunn
Associate Chief Counsel
(Domestic)

REGULATORY AND TAX TREATMENT OF ELECTRIC INTERCONNECTION FACILITIES

Jackie S. Levinson[*]
Andrew D. Schifrin[*]

I. INTRODUCTION

Over the last twenty-five years, the electric power industry has been transformed from one that favored vertically-integrated monopolies to one that now generally endorses competitive generation supply. The evolution of the industry has created new suppliers of power and new forms of grid ownership and governance. One of the issues generators have had to confront through this evolution is that of interconnecting a new plant to the grid. Without an interconnection, few generators would be able to serve load.

The Federal Energy Regulatory Commission (FERC) is currently considering the standardization of interconnection agreements and policies through a rulemaking proceeding.[1] Among other things, the FERC recognizes that a generator's payment for a grid owner's interconnection facilities has federal income tax implications.[2] The FERC's approach has been to allow parties to an interconnection agreement to include tax gross-ups or indemnity provisions.[3] While the FERC's order in the Interconnection Rulemaking may provide clarity with regard to which party bears the risk and the economic burden of taxes associated with an interconnection, it will not address the taxation of an interconnection *per se*. Instead, taxpayers, the Internal Revenue Service (IRS or Service), and perhaps Congress must address the federal income tax consequences of an interconnection transaction.

Taxes associated with interconnections will inherently affect the cost of power from, and the cost of entry for, competitive generators. Accordingly, utilities, generators, and consumers should each want the lowest possible tax burden. In addition, the tax liability is often significant and will affect the amount that needs to be recouped in either the generator's or the transmission owner's rates.[4] The parties to an interconnection agreement generally desire

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* Ms. Levinson practices tax law as a partner, and Mr. Schifrin practices energy law as counsel, at the law firm of King & Spalding. The authors would like to thank Ms. Jaime King and Mr. Jason Lewis, who are both associates at King & Spalding, for their significant contributions to this article. The views expressed in this article are those of the authors and do not necessarily reflect the views of their clients.

1. Notice of Proposed Rulemaking, *Standardization of Generator Interconnection Agreements and Procedures*, F.E.R.C. STATS & REGS. ¶ 32,560 (Apr. 24, 2002), 99 F.E.R.C. ¶ 61,086 (Apr. 24, 2002), 67 Fed. Reg. 22,250 (May 2, 2002) (to be codified at 18 C.F.R. pt. 35 (2002)) [hereinafter *Interconnection Rulemaking*].

2. *Id.* at 34,179, 34,208-34. This paper discusses United States federal income tax consequences only.

3. *Interconnection Rulemaking*, *supra* note 1, at 34,179, 34,208-34.

4. While the cost of interconnection facilities are project specific, the magnitude of costs and

and taxable treatment, the issue of what constituted a connection fee was heavily litigated.[153] Several issues were clarified by case law.

The cases examined what type of connection related specifically to a customer. Payments used for transmission and distribution lines were held not to be taxable connection fees.[154] Customer payments for service lines, which connected an individual customer to the utility's distribution line, however, were taxable.[155] Charges for transformers and transformer pads between the distribution line and underground lines to individual customers were taxable, although the court based its decision on one transformer per customer and analogized transformers to meters or service lines.[156] A service line that had the capacity to serve more than one customer was also held to be taxable. As long as a customer was paying for its connection, it made no difference if other customers could eventually be served on that line.[157] On the other hand, payments for a service line that serves more than one customer of a water or sewer utility are not considered connection fees under Treasury regulations.[158]

F. *Electric Interconnections*

Despite the varying public policies applied by the courts and Congress to the taxation of nonshareholder contributions to capital, the tax policy has always been that payments for services are taxable. It was with that background that the IRS approached the taxation of payments or transfers of property made by PURPA QFs.

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representing the cost of installing a connection or service line . . . from the utility's main water or sewer lines to the line owned by the customer or potential customer." *Id.* When Treas. Reg. § 1.118-2(b)(3) was proposed, several commentators argued that connection and service lines should not be treated as taxable customer connection fees because, in the reenactment in 1996, the explicit taxation of customer connection fees in former section 118(b)(3)(A) had been dropped. The Service disagreed, however, citing the legislative history to the 1996 Act which explained that the changes to section 118 were intended only to restore the contribution in aid of construction provision that was repealed in 1986 for regulated public utilities that provide water or sewerage disposal services and was not intended to change the longstanding treatment of customer connection fees. T.D. 8936, 2001-9 I.R.B. 720. Thus, the final regulations continue to make taxable fees for connection and service lines, excluding them from the definition of nontaxable contributions in aid of construction. Treas. Reg. § 118-2(b)(3) (2001).

153. Teco Energy, Inc. v. United States, 99-2 U.S.T.C. (CCH) 50,970 (M.D. Fla. 1999) (extension of facilities charges and residential electric underground extension payments are all taxable customer connection fees; no statutory support for distinction between whether one customer or many customers could be served); Florida Progress Corp. v. United States, 156 F. Supp. 2d 1265 (M.D. Fla. 1998) (underground extension charges are taxable connection fees; serve only one customer even though line is capable of serving more than one customer); Lake Superior Dist. Power Co. v. Comm'r, 701 F.2d 695 (7th Cir. 1983) (customer connection fees for overhead line extensions to customer, transformer charges, and underground service extension charges are all taxable fees for services); Grantham v. United States, 1982 U.S. Dist. LEXIS 17946 (E.D. Mo. 1982) (one time fees paid by customers for sewer lines whether or not there were already sewer lines adjacent to the customers' property and whether or not the company had to extend facilities to customers' property lines, not taxable connection fees but instead nontaxable contributions to capital).

154. *Grantham*, 1982 U.S. Dist. LEXIS 17946, at *33.

155. *Lake Superior Dist. Power Co.*, 701 F.2d at 703.

156. *Id.*

157. *Florida Progress Corp.*, 156 F. Supp. 2d at 1274.

158. Treas. Reg. § 1.118-2(b)(3)(ii)(A) (2001).

In IRS Notice 88-129, the IRS separated the taxation of interconnections from the long history of contributions in aid of construction.[159] Contributions in aid of construction were paid to a utility by a customer in order to help the utility sell service to that customer. These payments were of a different nature than interconnection payments. PURPA QFs typically sell power to utilities rather than buy power from utilities.[160] Payments by qualifying facilities for interties,[161] therefore, are generally not payments in aid of construction, even if the intertie is used to wheel power to other utility customers of the QF.[162] Only where an intertie could be used both to sell power to a utility and to buy power from a utility could the old debate arise as to what constituted a payment for services. In these situations, the IRS instituted a de facto de minimis test in which the utility could not receive an interconnection tax free and sell power to the QF of more than 5% of the total power flowing over the connection in the first ten taxable years, beginning with the year the connection was placed in service.[163]

Under IRS Notice 88-129 an interconnection payment will be tax-free only if three conditions are met. First, the intertie cannot be included in the utility's rate base. Second, the power purchase contract between the QF and the utility cannot be less than ten years in duration. Lastly, power flows over a "dual-use intertie" from the utility to the QF must, at the time of the transfer, be reasonably projected to meet the 5% test over the first ten years, based upon an independent engineer's report, if practicable. For these purposes, the utility can elect to exclude the year the property is placed in service.[164]

If the power flows exceed 5% in each of any three years within any period of five consecutive taxable years, the intertie is deemed to be transferred proportionately to the utility as a contribution in aid of construction. In determining the percentage of fair market value that would be transferred, the IRS takes facts and circumstances into account, including the historic and prospective use of the intertie. In a tax-free transfer, the QF, not the utility, amortizes the cost of the intertie as an intangible asset over an appropriate period. The utility has a zero basis in the facility.

If the utility obtains tax ownership of the property, when the power purchase contract expires, the utility is considered to receive the intertie (or the

159. I.R.S. Notice 88-129, 1988-2 C.B. 541.

160. *Id.*

161. An intertie "may include new connecting and transmission facilities, or modifications, upgrades or relocations of a utility's existing transmission network." I.R.S. Notice 88-129, 1988-2 C.B. 541. In the FERC's terminology, interties generally include direct assignment facilities and network upgrades. *See generally Southwest Power Pool, Inc.* 100 F.E.R.C. ¶ 61,248 (Sept. 5, 2002); *Entergy Gulf States, Inc.*, 99 F.E.R.C. ¶ 61,095, 61,399-400 (Apr. 25, 2002).

162. *Id.*

163. I.R.S. Notice 88-129, 1988-2 C.B. 541. "If for any taxable year power flows to the Qualifying Facility exceed 5% of total power flows over the intertie, then the utility must attach a statement to this effect to its return for such taxable year. If a power supply contract subject to the provisions of this notice terminates, the utility must attach a statement to this effect to its return for the year in which the termination occurs. The notification requirements . . . apply to taxable years ending more than 180 days after December 27, 1988. *Id.*

164. I.R.S. Notice 88-129, 1988-2 C.B. 541.

proportionate part of it not yet deemed to be transferred, in the case of the 5% limit having been exceeded) in a taxable transaction equal to the fair market value of the intertie at the time of transfer, reduced by any amount paid by the utility to the QF.[165]

Since establishing the framework for the taxation of interconnections, the IRS has refined the reach of the "safe harbor" of IRS Notice 88-129 but has not changed the criteria for a nontaxable transfer. In IRS Notice 90-60, the Service recognized that interconnections could be used by both the utility and the QF, with the utility paying fair market value for that use.[166] In that case, the utility is credited with extension allowances or similar payments in the taxable transfer that is deemed to take place at the end of the power purchase contract. The Service departed from the "willing buyer, willing seller" mode of determining fair market value and accepted the determination of the regulating utility commission that a payment by a utility at the end of a power purchase contract would be fair market value.[167] Finally, the fair market value of the interconnection at the end of a power purchase contract is determined by whether or not, and how, the utility intends to use the interconnection.[168] A utility that does not use the interconnection after the contract is taxable on the salvage value of the intertie.[169]

Changes to the electric power industry and its participants, as described above in Part I, left large gaps in the coverage of IRS Notice 88-129. In IRS Notice 2001-82, the Service extended the availability of the safe harbor of IRS Notice 88-129 to transfers of interconnections to utilities from non-qualifying facilities, *i.e.*, stand-alone generators, such as independent power producers and exempt wholesale generators.[170] IRS Notice 2001-82 also addresses cases involving interties that are used wholly or partially to wheel power to customers of the stand-alone generator. In those situations, the parties can transfer an intertie in connection with a long-term interconnection agreement between the utility and the stand-alone generator, the term of which is not less than ten years, and pursuant to which the ownership of the power that is wheeled by the utility passes to the purchaser prior to its transmission on the utility's grid.[171] The transfer of ownership will be deemed to be before transmission if title to the wheeled electricity passes to the purchaser at the busbar on the generator's end of the intertie. In addition, the safe harbor of IRS Notice 88-129 now covers dual-use interties by which the generator can buy power from a third party. Finally, IRS Notice 2001-82 requires the power generator to amortize the cost of

165. *Id.*

166. I.R.S. Notice 90-60, 1990-2 C.B. 345.

167. *Id.*

168. I.R.S. Notice 90-60, 1990-2 C.B. 345.

169. *Id.*

170. I.R.S. Notice 2001-82, 2001-52 I.R.B. 619. "For transfers of interties occurring on or before the December 24, 2001 effective date and meeting the requirements of this notice, taxpayers may request application of this notice through a request for a private letter ruling (including . . . circumstances where the taxpayer's return for the year of transfer has already been filed." *Id.*

171. I.R.S. Notice 2001-82, 2001-52 I.R.B. 619.

the interconnection as an intangible asset over twenty years on a straight-line basis.

IV. BEYOND IRS NOTICE 2001-82

To ascertain the tax burden of any interconnection payment, members of the electric industry have relied on the IRS notices[172] and have asked the IRS for guidance through private letter rulings.[173] Safe harbors and private letter rulings are time-consuming and lengthy procedures. Moreover, any safe harbor that the IRS tries to craft for the taxation of interconnections will inevitably leave gaps. This is understandable because any safe harbor has to define a situation in which the IRS is comfortable with the tax results, so the safe harbor will necessarily represent a fixed, and often conservative factual setting. What is needed is a more generic analytical framework for testing different situations as they arise.

The underlying tax policy question of whether a transfer is an advance payment for the performance of services is, in a sense, the second phase of the analysis that must be applied to the modern electric power industry. The proper first phase should be an analysis of whether, or when, a transfer has occurred. The tax law no longer looks to the transfer of bare legal title as determinative. Rather, an inquiry into which party enjoys the economic benefits and bears the economic burdens of ownership should be made to determine whether the power generator has, in a tax sense, transferred property to the utility in the first place. If a power generator retains tax ownership of the facility under a benefits-and-burdens analysis, it has not transferred property to the utility. An inquiry as to whether the utility has received a nonshareholder contribution to capital or a payment for services would be premature. On the other hand, if the utility bears the economic burdens and enjoys the economic benefits of the facility, a transfer has been made. It must then be determined whether the transfer of property was in payment for services, income of a more general character, a contribution to capital, or a transfer of some other nature, such as a loan.

The benefits-and-burdens analysis must necessarily take note of the treatment of interconnections by the FERC and the parties involved. Although nontax regulatory schemes are not generally determinative of tax consequences, the practical consequences of regulatory action influence, or dictate in some instances, who bears the economic burdens and enjoys the economic benefits of ownership. Certainly the IRS has taken note of regulatory aspects of the interconnection issue from the inception. IRS Notice 88-129 requires that for tax-free treatment the interconnection cannot be included in a utility's rate base. IRS Notice 90-60 accepts regulatory findings of fair market value in certain circumstances. Analyzing regulatory consequences in the context of determining the economic burdens and benefits of ownership makes sense. It will provide flexibility, without undermining the tax policy behind taxing payments for

172. I.R.S. Notice 2001-82, 2001-52 I.R.B. 619; I.R.S. Notice 90-60, 1990-2 C.B. 345; I.R.S. Notice 88-129, 1988-2, C.B. 541; I.R.S. Notice 87-82, 1987-2 C.B. 389.

173. In recent years the Service has issued private letter rulings regarding contributions to electric utilities. Priv. Ltr. Rul. 200224023 (Mar. 14, 2002); Priv. Ltr. Rul. 200134021 (May 30, 2001); Priv. Ltr. Rul. 200133036 (May 22, 2001); Priv. Ltr. Rul. 199920027 (Feb. 18, 1999).