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IRS Issues Private Letter Ruling Allowing Tax Equity Financing with a Regulated Utility Taxpayer.

In [Private Letter Ruling 201946007](#), the Internal Revenue Service (IRS) allowed a tax equity investor to participate with a regulated utility in a tax equity financing arrangement for wind investments without being subject to the tax normalization rules.

In Depth

Investments in renewable energy facilities can reduce reliance on fossil fuels, boost energy security and provide tax benefits, such as accelerated depreciation, the investment tax credit (ITC) under IRC § 48 and the production tax credit (PTC) under IRC § 45. The PTC incentivizes certain wind and other renewable energy projects by granting a per kilowatt-hour tax credit based on the amount of electricity produced; and the ITC provides a tax credit based on the amount of investment in solar facilities. Accelerated depreciation allows for greater tax deductions in the earlier years of a project's lifecycle at a faster pace than depreciation under regulatory or financial accounting standards. For many years, tax equity investors have partnered with non-regulated energy producers to obtain these tax attributes. Under a safe harbor established by Revenue Procedure 2007-65, a tax equity investor and an energy producer may enter into a partnership that holds renewable energy assets, and they can share the PTCs, depreciation deductions, any other tax items and cash that may be generated by the assets.

Before PLR 201946007, there was significant 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. The Code provides that tax normalization rules apply to utilities that can recover costs through rates set by a public utility commission. The tax normalization rules provide that, for purposes of recovering costs from customers, depreciation of public utility property cannot be recovered more rapidly than depreciation allowable for accounting purposes. ITCs are also subject to the tax normalization rules. The normalization rules allow a regulated utility to enjoy the full benefit of depreciation deductions and the ITC without having to immediately pass the benefits on to its ratepayers. The regulated utility can take these benefits over the useful life of the asset for regulatory purposes. If a regulated utility is not permitted by its public utility commission to use a normalized method of accounting, the utility is ineligible for accelerated depreciation and ITCs.

If a regulated utility partner entered into a tax equity partnership, it was unclear whether the partnership's wind assets would be public utility property, and therefore whether the tax equity investor could take accelerated depreciation. Because of this uncertainty, regulated utilities have generally not participated in tax equity structures.

In PLR 201946007, the Service addressed whether a new wind generation facility would be public utility property for purposes of determining whether the depreciation deductions from the facility would be subject to the normalization rules. The taxpayer planned to form a joint venture with an independent tax equity investor to invest in a wind facility. The joint venture would sell the

electricity generated by the wind facility to a disregarded affiliate of the taxpayer (Affiliate), a regulated utility, pursuant to a wholesale power purchase agreement (PPA). Affiliate would then sell the electricity to its customers. Rates under the PPA would be determined based on a competitive bidding process and market-based method, and not on a rate-of-return or cost basis. The taxpayer requested a ruling that the wind facility would not be Public Utility Property, so that the normalization rules would not apply.

The IRS looked at the rules under section 168(i)(10) and related regulations, which provide that a facility will only be treated as public utility property if the following three factors are met:

1. The facility 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. The wind facility clearly met the first two factors, but failed to satisfy the third because the PPA's rates were set on a market basis, and not a rate-of-return basis. As a result, the IRS ruled that the wind facility would not be public utility property. Therefore, the tax normalization rules will not apply.

This ruling is significant because it confirms that the normalization rules will not apply to wind generation facilities held by a partnership where the electricity is sold to the regulated utility investor at market rates, even though the utility sells the power at regulated cost-of-service or rate-of-return rates.

Practice Point: Regulated utilities can participate in tax equity structures, generating accelerated depreciation for tax equity investors.

Practice Point: Because the normalization rules also apply to the ITC, the IRS's letter ruling presents a road map for structuring solar investments with regulated utilities to fully maximize tax benefits.

McDermott Perspective: McDermott submitted the above ruling request on behalf of a Firm client.

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