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IRS Expands Favorable Tax Treatment to Utility Securitizations That Use a State or Political Subdivision as Issuer: Hunton Andrews Kurth

The Internal Revenue Service (“IRS”) issued a new [revenue procedure 2024-15](#) (the “2024 Rev. Proc.”) on February 29, 2024, allowing more types of utility securitization transactions to qualify for certain favorable tax treatment. The 2024 Rev. Proc. allows for a utility/sponsor to defer recognition of gross income until the related securitization charges are recognized in accordance with the utility usual method of accounting. The 2024 Rev. Proc. will allow utility securitization transactions using a state entity issuer to qualify for the same tax treatment as has been available to utility securitizations using a wholly owned special purpose entity of the utility. In addition, the 2024 Rev. Proc. modified the existing 2005 Rev. Proc. (as defined below) to provide that debt service payments in a qualifying securitization may be made annually. It also amended the definition of “Public Utility” under the 2005 Rev. Proc. to include any utility company that is subject to regulatory authority of a state public utility commission or other appropriate agency, thereby expanding the definition to include utilities that are not investor owned utilities.

Utility securitization is a form of debt financing secured by the right to bill and collect a dedicated, nonbypassable charge (the “Securitization Charge”) payable by the utility’s customers within the utility’s historic service territory. The Securitization Charge is created as a present property right pursuant to a state statute and financing order (referred to herein as “Securitization Property”) from the state public utilities commission (the “Regulatory Authority”). In the vast majority of transactions completed to date, the utility sells/transfers the Securitization Property to a wholly owned, bankruptcy remote special purpose vehicle (an “SPE”) created for the purpose of issuing securitization bonds secured by the Securitization Property. The utility uses the proceeds from the sale/transfer to recover discrete costs authorized to be recovered pursuant to the state statute and financing order.

In 2005, the IRS adopted revenue procedure 2005-62 (the “2005 Rev. Proc.”) which established that so long as the securitization is structured to meet the requirements outlined in the 2005 Rev. Proc., the utility will not recognize gross income upon (1) the receipt of a financing order from the Regulatory Authority, (2) the receipt of consideration in exchange for the sale/transfer of the Securitization Property to the SPE or (3) the receipt of consideration in exchange for the issuance of the securitization bonds by the SPE. Instead, the securitization bonds are treated as obligations of the utility and the Securitization Charges are treated as gross income to the utility recognized under the utility’s usual method of accounting.

A requirement of the 2005 Rev. Proc., however, is the securitization bonds are issued by an SPE wholly-owned by the utility. By adopting the 2024 Rev. Proc., securitization bonds issued by a state, political subdivision thereof or other organization authorized to issue debt on behalf of the state or political subdivision that is so designated pursuant to a qualifying securitization financing legislation as a financing entity (referred to therein as a “qualifying state financing entity”) will also be eligible for similar tax treatment, meaning the utility will not recognize gross income upon (i) the receipt of

the financing order, (ii) the sale/transfer of the Securitization Property to a qualifying state financing entity, (iii) the issuance of the securitization bonds by the qualifying state financing entity or (iv) the utility's receipt of ultimate proceeds from the securitization bonds issued. Furthermore, payments from the utility to the qualifying state financing entity pursuant to the securitization bonds will be treated as payments on obligations of the utility. Finally, the Securitization Charges will be treated as gross income of the utility recognized under the utility's usual method of accounting.

The expansion of the revenue procedure to cover bonds issued by a qualifying state financing entity will allow a transaction to be structured and sold by a municipal issuer similar to recent transactions sponsored by public utilities in Oklahoma and Texas that were used to recover costs associated with Winter Storm Uri without potentially adverse tax consequences to the sponsoring utility. In this structure, the sponsor utility will apply for a financing order from its Regulatory Authority pursuant to qualifying state legislation. The financing order will, among other things, authorize the bond issuance and create the Securitization Property which will be sold by the utility to the qualifying state financing entity in an absolute transfer and true sale and pledged for the benefit of bondholders.

Pursuant to many qualifying securitization statutes, there is a statutory test imposed upon any issuance of securitization bonds that structuring, marketing and pricing of the securitization bonds results in the lowest Securitization Charges consistent with market conditions at the time of pricing and the terms of the financing order. Prior to the 2024 Rev. Proc., sponsoring utilities analyzed and compared the costs of issuing securitization bonds through a registered public offering or a private offering in reliance on Rule 144A. Now with the 2024 Rev. Proc., utilities and underwriters in states where the qualifying securitization financing legislation permits the use of a state financing structure will now also need to analyze the benefits to customers from this new option. When analyzing the benefits of a state financing structure, it is important to note, however, that the 2024 Rev. Proc. does not address whether securitization bonds issued by a qualifying state financing entity would be exempt from federal income tax. Therefore, further analysis will be required, on a case by case basis, to determine if interest on the bonds could be exempt from federal income taxes.

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