Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Legend

Company =

ISO =
County =
State =
Issuer =
Date 1 =
a =
b =
1982 Bonds =
1992A Bonds =
1992B Bonds =

Dear :

This letter responds to a request on behalf of the Company by your representative for a ruling about whether certain of the Company's facilities will qualify as facilities for "the local furnishing of electric energy" within the meaning of § 142 of the Internal Revenue Code of 1986, as amended (the "1986 Code"), after the transactions described below.

FACTS:

Generally

The Issuer is a city and political subdivision of State. It is authorized by its charter and by enabling ordinances to issue revenue bonds and loan the proceeds to the Company. The Company is an investor-owned regulated public utility or IOU, which, among other things, provides electric energy to customers (the "Native Load Customers") within an electric service area consisting of County (the "Electric Service Area"). The Public Service Commission of the State (the "Commission"), acting pursuant to State statute, regulates the Company's provision of retail electric service, sets rates, and requires it to provide electric service to all those within its Electric Service Area that request such service.

Prior to Date 1, the Company wholly owned and operated a physically integrated system of generating, transmission and distribution facilities for electric energy located within the Electric Service Area that provided electric service throughout this area (the "Local System Facilities"). The Local System Facilities were not designed differently, sized larger, built sooner or constructed in a more costly manner than necessary to serve the customers in the Electric Service Area. They consist of land and property subject to the depreciation allowance provided in § 167. The Company has financed certain improvements and additions to its Local System Facilities with the proceeds of the 1982, 1992A, and 1992B Bonds.

Electric Industry Restructuring

On Date 1, the Company contributed a majority of its local high voltage transmission assets consisting of substations, lines with capacity of a KV or greater, related real property, easements, permits, and warranties (the "HVT Assets") to a newly formed, state-wide independent system operator for transmission of electric power, the ISO. The Company retained the remainder of its Local System Facilities: (a) its local electric distribution system; (b) its local generating units; (c) certain local high voltage transmission lines with capacity greater or equal to a KV that are used as distribution lines by high voltage customers; and (d) lines, regardless of capacity, that channel power in only one direction and also are used as distribution lines. The Local System Facilities less the contributed HVT Assets are referred to herein as the "Retained Facilities." The Company represents that less than 5 percent of the 1992A Bond proceeds and less than 10 percent of the 1982 Bond proceeds were used to finance the contributed HVT Assets. The 1992B Bonds were issued in order to refund the 1982 Bonds.

Following the transaction on Date 1, the Company operated, and intends to continue to operate the Retained Facilities as it has in the past and expects to be a net importer of electric energy with respect to these facilities. The Commission will require the Company to use the Retained Facilities to provide retail electric power to all customers in its Electric Service Area.

In conjunction with the transfer, the Company acquired shares of common stock in the ISO, representing approximately b percent of the ISO's outstanding stock. This equity interest is in proportion to the value of the Company's property contribution relative to the total value of the property contributed to the ISO by all of its members.

LAW AND ANALYSIS:

In general, § 103(a) of the 1986 Code provides that gross income does not include interest on any state or local bonds. Section 103(b) sets forth that this exclusion does not apply to any private activity bond that is not a "qualified bond" within the meaning of § 141 of the Code. Section 141(e) defines "qualified bond" to include an "exempt facility" bond.

Section 142(a)(8) provides that the term “exempt facility bond” includes any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide facilities for the local furnishing of electric energy or gas. For purposes of § 142(a)(8), § 142(f)(1) provides that the local furnishing of electric energy or gas shall only include furnishing solely within the area consisting of a city and one contiguous county, or two contiguous counties.

Under § 103(b)(4)(E) of the Internal Revenue Code of 1954 (the “1954 Code”), the predecessor to § 142(a)(8), interest paid on an issue of obligations issued by a state or local governmental unit is not includable in gross income if substantially all of the proceeds of such issue are to be used to provide facilities for the local furnishing of electric energy. Section 1.103-8(a)(1) of the Income Tax Regulations, issued under § 103(b)(4)(E), sets forth that substantially all of the proceeds of an issue of governmental obligations are used to provide an exempt facility if 90 percent or more of such proceeds are so used.

Section 1.103-8(a)(2) provides that in order to qualify as an exempt facility for the purposes of § 103(b)(4), and thus § 142(a), a facility must serve or be available on a regular basis for general public use or be a part of a facility so used.[1]

For purposes of applying the public use test in § 1.103-8(a)(2), § 1.103-8(f)(1)(ii) provides that a facility for the local furnishing of electric energy or gas is available for use by the general public if (a) the owner or operator of the facility is obligated, by a legislative enactment, local ordinance, regulation, or the equivalent thereof, to furnish electric energy or gas to all persons who desire such services and who are within the service area of the owner or operator of such facility, and (b) it is reasonably expected that such facility will serve or be available to a large segment of the general public in such service area.

Section 1.103-8(f)(2)(iii) provides that the term “facilities for the local furnishing of electric energy or gas” means property which --

> (a) Is either property of a character subject to the allowance for depreciation provided in § 167 or land,
>
> (b) Is used to produce, collect, generate, transmit, store, distribute, or convey electric energy or gas,
>
> (c) Is used in the trade or business of furnishing electric energy or gas, and

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[1]To the extent not amended, the Congress intended that principles of law under the 1954 Code continue apply under the 1986 Code. H. Conf. Rept. 99-841 (Vol. II), at II-686; 1986-3 (Vol. 4) C.B. 686.

> (d) Is a part of a system providing service to the general populace of one or more communities or municipalities, but in no event more than 2 contiguous counties (or a political equivalent) whether or not such counties are located in one State.
>
> A facility for the generation of electric energy otherwise qualifying under this subdivision will not be disqualified because it is connected to a system for interconnection with other utility systems for the emergency transfer of electric energy. The facilities need not be located in the area served by them.

Revenue Ruling 83-56, 1983-1 C.B. 22 (“Rev. Rul. 83-56") provides guidance for determining whether an asset of a utility is a “facility for the local furnishing of electricity” within the meaning of § 103(b)(4)(E) of the 1954 Code. The ruling concludes that a proposed hydroelectric generating plant was not a “facility for the local furnishing of electricity” because the plant was part of a regional electrical system serving customers in multiple counties. The ruling also concludes that the system described under § 1.103-8(f)(2)(ii)(d) means the public utility and the facilities needed to produce and deliver electricity to customers within the utility’s service area, as referred to in §§ 1.103-8(a)(2) and 1.103-8(f)(1)(ii).

Revenue Ruling 80-11, 1980-1 C.B. 22 (“Rev. Rul. 80-11") describes a local public utility that through its existing distribution system was in the business of furnishing gas to its customers that were located solely within two contiguous counties. The ruling held that certain specified additions, improvements, and replacements of the existing distribution system are facilities for the local furnishing of gas within the meaning of former § 103(b)(4)(E) because they satisfied the requirements under § 1.103-8(f)(2)(iii).

For purposes of § 1.103-8(f)(2)(iii)(d), the local system described under Rev. Rul. 80-11 was a gas distribution system that furnished gas to its customers solely within two contiguous counties. The gas utility’s local distribution system relied on accessing gas through regional pipelines. The distribution system then delivered the gas to customers within its service area. This arrangement is analogous to an electric distribution system, where a local distribution system accesses electricity through interconnections to regional transmission lines and generators.

The Company has requested the following rulings:

1. That the transfer of all of its HVT Assets will not cause the Retained Facilities to be other than facilities for “the local furnishing of electric energy” as defined in § 142(a)(8) of the 1986 Code and the regulations thereunder.

2. That the Company’s acquisition of a minority stock interest in the ISO, in return for the transfer of the HVT Assets, will not cause the Retained Facilities to be

other than facilities for “the local furnishing of electric energy” as defined in § 142(a)(8) and the regulations thereunder.

The essential issue to be decided with respect to the Company’s first ruling request is whether the Retained Facilities meet the requirements to be “facilities for the local furnishing of electric energy.”

The Company is a regulated public utility that is authorized and required to provide electricity to all those who request it in its Electric Service Area, and thus satisfies the exempt facility public use requirements set forth under §§ 1.103-8(a)(2) and 1.103-8(f)(1)(ii). In addition, it represents that the Retained Facilities will consist of property of a character subject to the depreciation allowance provided in § 167 and land and thus meets the requirement under § 1.103-8(f)(2)(iii)(a). The Retained Facilities also meet the requirements under § 1.103-8(f)(2)(iii)(b) and (c) as they are used to distribute electric energy in the course of the Company’s trade or business of furnishing electric energy.

The Company’s Electric Service Area qualifies under § 142(f) because it consists only of County. The Retained Facilities also meet the requirements of § 1.103-8(f)(2)(iii)(d). They are a part of a system providing electric service to the general population in the Electric Service Area. Similar to the gas distribution system described under Rev. Rul. 80-11, the Company will integrate the Retained Facilities with access to generation and transmission capacity through its interconnections with other utilities, deliver the electricity to its Native Load Customers through its distribution lines, and will be a net annual importer of electric energy. Therefore, we conclude that the Company’s Retained Facilities qualify as facilities for the local furnishing of electric energy.

The second ruling request asks whether ownership by the Company of a minority stock interest in the ISO will impair its status as a “system for the local furnishing of electricity” under § 142(a)(8). On the condition that the Company’s ownership interest will not permit the ISO to change the way that the Company’s Retained Facilities have been operated and are expected to be operated in the future, ownership of b percent of common stock in the ISO will not cause the Company’s system to be other than facilities for the local furnishing of electricity.

CONCLUSION:

Based upon the facts and representations outlined in this letter and in the taxpayer’s submissions, and provided the foregoing conditions are met, the transfer of the HVT Assets to the ISO and the Company’s b percent equity interest in the ISO will not cause the Company’s Retained Facilities to be other than facilities for “the local furnishing of electric energy” for purposes of §§ 142(a)(8) of the 1986 Code and the regulations thereunder.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the above described facts. Specifically, we express no opinion concerning whether the interest on the 1982, 1992A, or 1992B Bonds issued to finance the taxpayer's facilities is excludable from gross income under § 103(a).

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

Sincerely,
Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)
By: Timothy L. Jones
Assistant Branch Chief
Tax Exempt Bonds Branch