IRS Updates Safe Harbor for Transfers of Interties to Utilities

On June 10, the IRS issued Notice 2016-36, available at https://www.irs.gov/pub/irs-drop/n-16-36.pdf (the "Notice"), which updates and expands the existing safe harbor[1] pursuant to which the transfer of an intertie (or reimbursement for the cost thereof) to a regulated public utility will be treated as a contribution to the capital of a corporation, and not a contribution in aid of construction ("CIAC") and, accordingly, will not result in taxable income to the utility.[2]. Utilities often require developers of new projects to transfer interties as a condition to allowing the developers to transmit the power from their projects over the utility's lines.

The safe harbor is relevant to the renewable energy industry because, in addition to requiring the developer of a new power plant, whether of renewable or conventional power, to bear the cost for new or upgraded transmission equipment that is then transferred to the utility for free, the utility will often require that the power plant developer pay a "tax gross up" if the utility must treat the transfer as a CIAC or recognize the transfer as taxable income. The stated intent of the Notice is to facilitate the development and interconnection of renewable energy resources, and it is expected that the industry will view the revised safe harbor requirements under the Notice favorably.

The requirements of the revised safe harbor are:

1. Over the ten year period beginning when the contributed intertie is placed in service,[3] no more than 5% of the power that will flow over the contributed intertie (i.e., flowing *to* and *from* the utility) can be flowing *from* the utility *to* the generator. In most instances, this should not be a problem.

2. If the electricity from the project that the utility required the intertie for is wheeled over the utility's transmission system, ownership of the wheeled electricity must remain with the project prior to the electricity's transmission into the grid. This requirement is considered satisfied if title to the electricity passes to the purchaser on the project's side of the intertie.

3. The utility must not include the cost of the intertie in its "rate base." (This is not likely to be an issue, as the utility did not pay for the intertie.)

4. The intertie must be used for transmitting electricity.

5. The owner of the project must capitalize the cost of the intertie as an intangible that is amortized straight-line over 20 years.

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[1] The existing safe harbor is provided under a series of notices issued by the IRS between 1988 and 2001. See Notice 2001-82, 2001-2 C.B. 619; Notice 90-60, 1990-2 C.B. 345; and Notice 88-129, 1988-2 C.B. 541.

[2] See I.R.C. §§ 118(a) and (b) (contributions to the capital of a corporation are excluded from taxable income; the term "contribution to capital" does not include any CIAC).

[3] The Notice also permits the utility to opt not to include the first year in which the contributed intertie is placed in service. The availability of the safe harbor is determined based on the projected flow of power. The Notice also has rules for income recognition in the event the safe harbor is terminated because, for example, the 5% limit is exceeded during the first ten years, notwithstanding expectations to the contrary.

Energy Storage

An important change made under the Notice is that developers of storage facilities are eligible for the safe harbor, and thus will be able to contribute interties to a utility tax free. This was not the case under the previous IRS notices. The Notice explains this change as reflecting the fact that energy storage has become important to grid stability.

Removal of the Long-Term PPA or ICA Requirement

The other significant change made by the Notice is the removal of the requirement that the transfer be made by the developer of a facility that has either a long-term power purchase agreement ("PPA") or a long-term interconnection agreement ("ICA") with the utility receiving the intertie. In the past, it was typical that a developer of a power plant would only need to provide an intertie to the local transmission provider and, in that case, it would not be unusual to expect that the arrangement would also include a long-term PPA or ICA. The Notice recognizes the need to remove this requirement given the evolution of the market. For example, wind and solar power are often generated a long distance from the markets that purchase the power generated by these projects, which results in the developer of these projects being required to pay for transmission upgrades with distant utilities with which the project will not have an ICA or PPA.

Addition of Upgrades to Distribution Systems

Further, wind and solar are intermittent (i.e., solar power is not produced at night and far more wind power is produced at night than during the day), and that intermittency can strain not only transmission systems but also distribution systems.[4] Therefore, a utility may require a new or upgraded intertie for its distribution system prior to allowing wind or solar power to traverse such a system. The Notice expands the safe harbor to include intertie distribution upgrades provided by developers.[5]

[4] Transmission lines are large high voltage lines that carry electricity over long distances, while distribution lines are lower in voltage and deliver electricity to end users. *See https://www.dom.com/corporate/what-we-do/electricity/transmission-lines-and-projects/comparison-of-transmission-and-distribution-lines*.

[5] On this point, the Notice provides: "Because no long-term power purchase contract or long-term interconnection agreement is required under the new safe harbor, a generator (such as a solar or wind farm) may contribute an intertie to a utility that qualifies under the new safe harbor even if the generator is interconnected with a distribution system, rather than a transmission system, if all of the requirements [of the safe harbor] are met."