Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:6-PLR-118389-99
Date:
September 5, 2000

Legend:

Taxpayer =

Company 1 =
Company 2 =

Company 3 =
Company 4 =
Company 5 =

Utility =

Seller 1 =
Seller 2 =

Commission A =
Commission B =

Plant 1 =
Plant 2 =
Plant 3 =
Plant 4 =
Plant 5 =

District =

State =

<u>a</u> =
<u>b</u> =
<u>c</u> =
<u>d</u> =

This letter responds to your request, dated November 17, 1999, that we rule on certain tax consequences of the sale of the Plant from Sellers to Taxpayer. As set forth below, you have requested rulings regarding the tax consequences under section 468A of the Internal Revenue Code to the Sellers' qualified nuclear decommissioning funds as well as rulings regarding the proper realization and recognition of gain and loss on the sale of the Plant and the proper allocation of basis.

The Taxpayer has represented the following facts and information relating to the ruling request:

The Taxpayer is a limited liability company whose sole member is Company 1. The Taxpayer will be disregarded as a separate entity for Federal income tax purposes. Company 1 is a limited liability company whose sole member is Company 2. Company 1 will be disregarded as a separate entity for Federal income tax purposes. Company 1 is a generation holding company that owns all of the shares of the Taxpayer and Companies 3 and 4. Company 1 will supply administrative services to its subsidiaries and will be responsible for financing their operations.

Company 3 is a special-purpose, wholly-owned subsidiary of Company 1 that was formed to acquire, hold, and operate the non-nuclear generating facilities of the group. The Taxpayer is a special-purpose, wholly-owned subsidiary of Company 1 that was formed to acquire, hold, and operate the nuclear generating facilities of the group. The Taxpayer will sell all of its electric generation capacity and electric energy output to Company 4. Company 4 is a special-purpose, wholly-owned subsidiary of Company 1 that was formed to market power and energy that it purchases from the Taxpayer and Company 3, as well as from other sources, and to engage in wholesale marketing, brokering, and trading activities.

Company 2 is undertaking an internal restructuring. Utility is a wholly-owned subsidiary of Company 2 and owns interests in fossil and hydroelectric generating stations as well as interests in the Plants. Utility is currently regulated by Commissions A and B as well as by the Nuclear Regulatory Commission (NRC).

The State legislature enacted energy restructuring legislation that will cause the Utility to transfer all of its generating stations to affiliated companies. The Utility will transfer its fossil and hydroelectric generating assets to Company 3. The Utility will transfer its nuclear assets (the Plants) to the Taxpayer. In connection with the transfer of the Plants, the Utility will transfer to the Taxpayer its interests in the qualified and non-qualified nuclear decommissioning funds associated with each of the Plants. Also in connection with this transfer, the Taxpayer will assume all liability for decommissioning the Plants. After restructuring, Commission A will allow the Utility to collect decommissioning costs through a non-bypassable charge assessed on all ratepayers. The Utility will transfer the right to received these payments to the Taxpayer. After acquiring an interest in one of the Plants, the Taxpayer will be subject to various regulation by Commission B and the NRC.

On a, Company 1 entered into five asset purchase agreements to acquire interests in the Plants. In exchange for the Plants and associated assets, including qualified and non-qualified nuclear decommissioning funds, Company 1 will pay cash to the Sellers and will assume the Sellers' share of all liabilities for decommissioning the Plants. These agreements are summarized below:

1. An agreement between Seller 1, Company 5, and Company 1, whereby the Taxpayer and Company 5 will purchase a b undivided interest as tenants in common without the right of partition in Plants 1 and 2, with one-half of this interest being acquired by each purchaser.

2. An agreement between Seller 2, Company 5, and Company 1, whereby the Taxpayer and Company 5 will purchase a b undivided interest as tenants in common without the right of partition in Plants 1 and 2, with one-half of this interest being acquired by each purchaser.

3. An agreement between Seller 1 and Company 1, whereby the Taxpayer will purchase a c interest in Plants 3 and 4.

4. An agreement between Seller 2 and Company 1, whereby the Taxpayer will purchase a c interest in Plants 3 and 4.

5. An agreement between Seller 1 and Company 1, whereby the Taxpayer will purchase a d interest in Plant 5.

Requested Ruling #1: Pursuant to section 1.468A-6 of the Income Tax Regulations, the Sellers' qualified nuclear decommissioning funds will not be disqualified upon transfer to the Taxpayer and neither the Taxpayer nor its qualified nuclear decommissioning funds will recognize gain or loss or otherwise take any income or deduction into account by reason of the transfer of the assets of the Seller's qualified fund to the qualified fund of the Taxpayer at closing, and the Taxpayer's qualified funds will have a carryover basis in the assets received from the qualified funds of the Seller.

Requested Ruling #2: Subsequent to the closing the Taxpayer's qualified nuclear decommissioning funds will continue to be treated as qualified nuclear decommissioning funds under section 468A after receiving the assets transferred from the qualified funds of the Seller.

Section 468A(a) provides that a taxpayer may elect to deduct payments made to a nuclear decommissioning reserve fund (the qualified fund). Section 468A(b) limits the annual deduction of the electing taxpayer to the lesser of the ruling amount or the amount of decommissioning costs included in the electing taxpayer's cost of service for ratemaking purposes for the taxable year.

Section 468A(d) provides that the ruling amount means the amount determined by the Service to be necessary to (A) fund that portion of the nuclear decommissioning cost with respect to the nuclear power plant that bears the same ratio to the total nuclear decommissioning costs with respect to such nuclear power plant as the period for which the fund is in effect bears to the estimated useful life of the nuclear power plant, and (B) prevent any excessive funding of such costs or the funding of such costs at a rate more rapid than level funding.

Section 468A(e)(2) provides that the rate of tax on the income of a qualified fund is 20 percent. Section 468A(4) provides, in pertinent part, that the assets in a qualified fund shall be used exclusively for satisfying the liability of any taxpayer contributing to the qualified fund.

Section 1.468A-1(b)(1) of the Federal Income Tax Regulations provides that an eligible taxpayer is a taxpayer that possesses a qualifying interest in a nuclear power plant. Section 1.468A-1(b)(2) provides that a qualifying interest is a direct ownership interest or a leasehold interest meeting certain additional requirements. Section 1.468A-1(b)(4) provides, in part, that a nuclear power plant is any nuclear power reactor that is used predominantly in the trade or business of the furnishing or sale of electric energy, if the rates for such furnishing or sale, have been established or approved by a public utility commission.

Section 1.468A-5(a) sets out the qualification requirements for nuclear decommissioning funds. It provides, in part, that a qualified fund must be established and maintained pursuant to an arrangement that qualifies as a trust under state law. An electing taxpayer can establish and maintain only one qualified fund for each nuclear power plant. Section 1.468A-5(c)(1)(i) provides that if, at any time during the taxable year, a nuclear decommissioning fund does not satisfy the requirements of section 1.468A-5(a) the Service may disqualify all or a portion of the fund as of the date that the fund does not satisfy the requirements. Section 1.468A-5(c)(3) provides that if a qualified fund is disqualified the fair market value (with certain adjustments) of the assets in the fund is deemed to be distributed to the electing taxpayer and included in that taxpayer's gross income for the taxable year.

Section 1.468A-6 generally provides rules for the transfer of an interest in a nuclear power plant (and transfer of the qualified fund) where after the transfer the transferee is an eligible taxpayer. Under section 1.468A-6(g), the Service may treat any disposition of an interest in a nuclear power plant occurring after December 27, 1994, as satisfying the requirements of the regulations if the Service determines that such treatment is necessary or appropriate to carry out the purposes of section 468A.

Under the specific facts herein, the Service will exercise its discretion to treat this sale, under section 1.468A-6(g), as a disposition qualifying under the general provisions of section 1.468A-6. This exercise of discretion is specifically based on the continued general supervision of the qualified fund by the Nuclear Regulatory Agency. This exercise of discretion, however, applies to the provisions of 1.468-6 except those outlined in 1.468A-6(e) with respect to the calculation of a schedule of ruling amounts subsequent to a sale. Thus, under section 1.468A-6 the qualified nuclear decommissioning funds of the Seller will not be disqualified upon the sale when the assets are transferred to the Taxpayer's qualified funds and those funds, holding the transferred qualified assets will be treated as a qualified funds of the Taxpayer.

Section 1.468A-6(c)(2) provides that neither a transferee nor its fund will recognize gain or loss or otherwise take any income or deduction into account by reason of the transfer of the assets from a transferor's qualified fund to a transferee's qualified fund. Thus, the Taxpayer will not recognize gain or loss or otherwise take any income or deduction into account by reason of the transfer of the Seller's qualified funds assets to the Taxpayer's qualified funds.

Finally, section 1.468A-6(c)(3) provides that transfers of assets of a qualified fund to which section 1.468A-6 applies do not affect basis. Accordingly, under section 1.468A-6(c)(3), the Taxpayer's qualified funds will have a basis in their assets that is the same as the basis of those assets in the qualified funds of the Seller immediately before the sale. Thus, the Taxpayer's qualified funds will, after the sale, have a carryover basis in the assets transferred from the Seller.

Requested Ruling #3: In the taxable year of closing, the Taxpayer will not recognize any gain or otherwise take any income into account by reason of the transfer of the assets of the Seller's nonqualified decommissioning funds to the Taxpayer's nonqualified funds.

Generally, a taxpayer does not realize gross income upon its purchase of business assets, even where those assets include cash or marketable securities and, in connection with the purchase, the taxpayer assumes liabilities of the Seller. See Commissioner v. Oxford Paper, 194 F.2d 190 (2d Cir. 1952); Rev. Rul. 55-675, 1955-2 C.B. 567. In this case, Taxpayer cannot acquire the Plant without assuming the decommissioning liability, which is inextricably associated with ownership and operation of the Plant, and there is no indication that the transaction is other than a bona fide purchase of the business and its associated assets and liabilities. The exception to the general rule set forth in Rev. Rul. 71-450, 1971-2 C.B. 78, does not apply. In Rev. Rul. 71-450, unlike the present situation, the purchaser agreed to assume the prepaid subscription liability in return for a separate cash payment, and the liability was not reflected in the sales price of the business.

Accordingly, Taxpayer will not recognize income from its acquisition of the Plants and related non-qualified decommissioning funds except to the extent, under the rules of section 1060, the Class I assets (as defined in section 1.338-6T(b)(1)) it receives (excluding the assets in the qualified nuclear decommissioning funds) exceed its total cost determined under section 1012 (which will be the sum of its cash consideration and the fair market value of any other consideration it provides to Seller that is, under applicable tax principles, taken into account on the date of the applicable asset acquisition). Section 1.338-6T(b)(1). The Taxpayer will be permitted to take additional consideration into account only when it satisfies the economic performance requirement with respect to the decommissioning liability assumed.

These conclusions are conditioned on Taxpayer including in basis only the cash paid to Seller, plus any liabilities that are otherwise incurred for federal income tax purposes, and allocating this consideration pursuant to the residual method under section 1060 and the regulations thereunder. Pursuant to section 461(h) and the regulations thereunder, Taxpayer will not be entitled to treat as a component of its cost basis at the time of the closing any amount attributable to the additional future decommissioning liabilities assumed in the transaction. In addition, the Taxpayer will take the assumption of the decommissioning liability into account using the residual method under section 1060 (discussed below) when and to the extent that the decommissioning funds pay or incur decommissioning costs.

Section 1060 provides that, in the case of an “applicable asset acquisition,” the consideration received shall be allocated among the acquired assets in the same manner as amounts are allocated to assets under section 338(b)(5). Section 1.1060-1T(a)(1) provides that, in the case of an applicable asset acquisition, sellers and purchasers must allocate consideration under the residual method described in section 1.338-6T and 1.338-7T in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets.

Section 1060(c) defines the term “applicable asset acquisition” as the transfer of assets constituting a trade or business if the acquirer’s basis in the transferred assets is determined wholly by reference to the consideration paid for such assets.

Section 1.1060-1T(c)(1) defines a purchaser’s consideration as the amount, in the aggregate, of its cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis. Section 1060 provides no independent basis for determining a taxpayer’s cost of acquired assets. Cost is determined solely under generally applicable rules of tax accounting.

The residual method is based on a division of assets into seven classes: Class I (generally consisting of cash, and general deposit accounts held in banks, savings and loan associations, and other depository institutions), Class II (generally consisting of actively traded personal property like U.S. government securities and publicly traded stock, but also including certificates of deposit and foreign currency even if they are not actively traded personal property), Class III (accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business), Class IV (stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business), Class V (all assets other than Class I, II, III, IV, VI, and VII assets), Class VI (all section 197 intangibles, as defined in section 197, except goodwill and going concern value), and Class VII (goodwill and going concern value, whether or not it qualifies as a section 197 intangible).

Consideration is first reduced by the amount of Class I assets received by the purchaser. The remaining consideration is then allocated to the Class II assets (pro rata, to the extent of their fair market value), then to the Class III assets (pro rata, to the extent of their fair market value), then to the Class IV assets (pro rata, to the extent of their fair market value), then to the Class V assets (pro rata to the extent of their fair market value), then to the Class VI assets (pro rata to the extent of their fair market value), and, finally, any remaining consideration is allocated to the Class VII assets. Sections 1.1060-1T(c)(2), 1.338-6T(b)(1), and 1.338-6T(b)(2).

The following example illustrates the operation of section 1060: On Date 1, an applicable asset acquisition is made. The assets acquired consist of Class I assets in the amount of $50, Class II assets with a fair market value of $350, Class III assets with a fair market value of $100, Class IV assets with a fair market value of $150, and Class V assets with a fair market value of $100, there are no Class VI or Class VII assets. The consideration consists of $150 cash and an assumed liability for which economic performance has not occurred. On Date 1, the purchaser has provided $150 of consideration that may be allocated as basis; it will be first reduced by $50 (the amount of Class I assets); the remaining $100 will be allocated to Class II assets (pro rata according to fair market value); nothing is allocated to Class III or below. On Date 2, economic performance occurs with respect to the liability to the extent of $300; at that time, the purchaser has an additional $300 of basis that may be taken into account. Of that amount, $250 is allocated to Class II assets (which will then have been allocated their full $350 fair market value--as determined on the acquisition date), and the remaining $50 is allocated to the Class III assets (pro rata according to fair market value--as determined on the acquisition date). On Date 3, economic performance occurs to the extent of an additional $400, which is then taken into account as basis. Of that amount, $50 will be allocated to the Class III assets (which will then have been allocated their full $100 fair market value--as determined on the acquisition date), $150 will be allocated to the Class IV assets (which will then have been allocated their full $150 fair market value–as determined on the acquisition date), $100 will be allocated to the Class V assets (which will then have been allocated their full $100 fair market value–as determined on the acquisition date), and the remaining $100 will be allocated to the Class VII assets. (The last amount is allocated to goodwill even though goodwill was not identified as a separate asset having value on Date 1). If, on Date 3, instead of an addition to purchaser's consideration, there is a $100 decrease in consideration, the consideration previously allocated to the Class III assets would be reduced to zero and the consideration previously allocated to the Class II assets would be reduced by the remaining $50 (pro rata according to fair market value).

With respect to the plants, equipment, operating assets, and assets of the nonqualified funds, these assets comprise a trade or business in Sellers' hands and the basis Taxpayer takes in those assets will be determined wholly by reference to Taxpayer's consideration. Thus, Sellers' transfer of the plants, equipment, operating assets, and assets of the nonqualified funds to Taxpayer in exchange for cash and the assumption of the decommissioning liability (except to the extent funded by the qualified funds) is an applicable asset acquisition as defined in section 1060(c). As such, its federal tax treatment is determined under section 1060 and the regulations thereunder.

On the acquisition date, Taxpayer's basis in the assets acquired must be determined by allocating its cost (i.e., the consideration provided by Taxpayer on the acquisition date, which includes the cash, but not the assumption of the decommissioning liability) among the acquired assets in accordance with the provisions of section 1060 and the regulations thereunder. Specifically, Taxpayer will first reduce its consideration by the amount of the Class I assets it receives in the transaction (including any Class I assets held in the nonqualified funds); to the extent the Class I assets received exceed the consideration Taxpayer provides, Taxpayer will recognize income. To the extent Taxpayer's consideration exceeds the Class I assets it receives, such excess will be allocated to the Class II assets, pro rata according to the fair market value of those assets, up to their total fair market value. We believe the combined value of Sellers' Class I and Class II assets (as defined in section 1.338-6T(b)(1) and (b)(2)(ii)) will exceed the cash Taxpayer will pay on the acquisition date. As such, the total amount of consideration to be allocated to the Class II assets will be less than their fair market value and no consideration will be allocated to assets in Classes III, IV, V, VI, or VII. When and to the extent additional amounts are paid or incurred for the assets acquired in the applicable asset acquisition (e.g., when and to the extent the nonqualified funds pay or incur decommissioning expenses), such amounts will be taken into account as increases to Taxpayer's consideration and allocated in the same manner and subject to the same conditions as though they were paid or incurred on the acquisition date. Sections 1.1060-1T(a)(1), 1.1060-1T(c)(2), 1.338-6T, and 1.338-7T.

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

In accordance with the powers of attorney, we are sending a copy of this ruling letter to your authorized representatives. We are also sending a copy of this letter to the Director of the District.

Sincerely,
CHARLES B. RAMSEY
Chief, Branch 6
Office of Assistant Chief Counsel
Passthroughs and Special Industries