

*26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 61, 446, 451.)*

Rev. Proc. 2005-35

SECTION 1. PURPOSE

This revenue procedure sets forth a safe harbor method of accounting for a Utility's treatment of an Up-front Payment that the Utility receives from a Generator to finance Network Upgrades to the Utility's Transmission System. This revenue procedure also provides a procedure for a Utility to obtain automatic consent of the Commissioner to change to the safe harbor method of accounting. Finally, this revenue procedure provides audit protection to a Utility that has used the safe harbor method of accounting, provided that certain conditions are satisfied.

SECTION 2. BACKGROUND

.01 A Utility is required pursuant to Federal Energy Regulatory Commission (FERC) rules and policy to accommodate any request from a Generator to interconnect the Generator to the Utility's Transmission System. In general, for a Generator to begin providing electricity from its facility to its customers over a Utility's Transmission System, certain Network Upgrades must be made to the Transmission System to accommodate the addition of the facility's electricity. Under FERC policy, costs of the Network Upgrades generally must be paid in advance to the Utility in the form of an Up-front Payment by the interconnecting Generator. To comply with FERC policy, the Interconnection Agreement between the Utility and the Generator typically requires that the Generator's Up-front Payment to the Utility be reimbursed by the Utility.

.02 The FERC standard Interconnection Agreement, FERC Order No. 2003-B

issued December 20, 2004 (70 FR 265), requires that the Utility reimburse the Generator's Up-front Payment in cash, plus make additional payments to the Generator that are designated as interest by FERC Order No. 2003-B ("FERC Interest"). Prior FERC approved Interconnection Agreements permit the Utility to make reimbursements in cash, in assignable transmission credits that may be used to offset the cost of transmission services, or in a combination of cash and assignable transmission credits.

.03 The IRS has received numerous inquiries about how Utilities should treat Up-front Payments for federal income tax purposes.

.04 Section 1.446-1(e)(3)(ii) of the Income Tax Regulations authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting.

.05 Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432) provides procedures by which a taxpayer may obtain automatic consent to change to a method of accounting described in the Appendix of Rev. Proc. 2002-9.

.06 Section 2.04 of Rev. Proc. 2002-9 provides that unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in method of accounting, regardless of whether the change is from a permissible or an impermissible method. See generally Rev. Rul. 90-38, 1990-1 C.B. 57.

SECTION 3. SCOPE

This revenue procedure applies to a Utility that receives an Up-front Payment from a Generator to finance Network Upgrades to the Utility's Transmission System.

SECTION 4. DEFINITIONS

The following definitions apply for purposes of this revenue procedure:

.01 *Commercial Operation Date* means the date on which the Generator commences commercial operation of its facility after trial operation of such facility has been completed and confirmed in writing as prescribed by FERC.

.02 *Generator* means the owner or operator of an electric generation facility.

.03 *Interconnection Agreement* means the agreement entered into between a Utility and a Generator for the purpose of interconnecting the Generator with the Utility's Transmission System.

.04 *Network Upgrades* mean the additions, modifications, and upgrades to the Transmission System required at or beyond the point at which the Generator interconnects to the Transmission System to accommodate the interconnection of the Generator to the Transmission System.

.05 *Transmission System* means the facilities owned, controlled, or operated by a Utility that are used to provide electric transmission service, including any additions, modifications, or upgrades made to such facilities.

.06 *Up-front Payment* means the amount or amounts paid by a Generator to a Utility pursuant to their Interconnection Agreement for costs with respect to Network Upgrades to the Utility's Transmission System.

.07 *Utility* means an electrical transmission or distribution system owner or operator that is subject to the regulatory authority of FERC as well as a State public utility commission or other appropriate State agency.

SECTION 5. APPLICATION

.01 For federal income tax purposes, if an Up-front Payment is made pursuant to an Interconnection Agreement that satisfies all of the conditions of either section 5.02 or 5.03 of this revenue procedure, whichever is applicable, a Utility may treat that Up-front Payment as not being taxable income under § 61 of the Internal Revenue Code when received (the "safe harbor method"). In addition, a Utility that uses the safe harbor method is not entitled to any deduction for its reimbursements of the Up-front Payment. To the extent that FERC Interest is deductible, it must be properly allocated to the periods in which it accrues.

.02 For Interconnection Agreements entered into on or after December 20, 2004:

(1) The Interconnection Agreement must entitle the Generator to receive reimbursement of an amount that is not less than the amount of the Up-front Payment;

(2) The Interconnection Agreement must require reimbursement of the Up-front Payment to be made in cash;

(3) The Interconnection Agreement must require that the Utility pay the Generator FERC Interest calculated in accordance with FERC Order No. 2003-B; and

(4) The Interconnection Agreement must require full reimbursement of the Up-front Payment, plus the FERC Interest calculated in accordance with FERC Order No. 2003-B, to be paid to the Generator no later than twenty (20) years after the Commercial Operation Date.

.03 For Interconnection Agreements entered into before December 20, 2004:

(1) Pursuant to the Interconnection Agreement, the Generator either has received, or must be entitled to receive, reimbursement of an amount that is not less than the amount of the Up-front Payment;

(2) The Interconnection Agreement must require reimbursement of the Up-front Payment to be made either in cash, assignable transmission credits, or a combination of both; and

(3) On July 11, 2005, the Utility must reasonably expect that under the terms of the Interconnection Agreement, full reimbursement of the Up-front Payment will be made no later than twenty (20) years after the Commercial Operation Date.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING

.01 *In general.* A change in a Utility's treatment of an Up-Front Payment, including a change to the safe harbor method provided in section 5.01 of this revenue procedure, is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. For Up-front Payments received pursuant to Interconnection Agreements that satisfy the conditions of section 5.02 or 5.03 of this revenue procedure, whichever is applicable, a Utility must follow section 6.02 or 6.03 of this revenue procedure to change its treatment of the Up-front Payments to

the safe harbor method provided in section 5.01 of this revenue procedure.

.02 *Automatic change.* A Utility within the scope of this revenue procedure that desires to change its treatment of Up-front Payments to the safe harbor method provided in section 5.01 of this revenue procedure for any taxable year ending on or after July 11, 2005, must follow the automatic change in accounting method provisions of Rev. Proc. 2002-9 (or its successor), with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply for the first taxable year ending on or after July 11, 2005; and

(2) The Utility must prepare and file a Form 3115 in accordance with section 6 of Rev. Proc. 2002-9 and must enter the designated number for the automatic change in method in Line 1a of Form 3115. The designated number for the automatic accounting method change to the safe harbor method provided in section 5.01 of this revenue procedure is "91".

.03 *Change for prior taxable years.* A Utility within the scope of this revenue procedure that desires to change its treatment of Up-front Payments to the safe harbor method provided in section 5.01 of this revenue procedure for any open taxable year in a series of consecutive open taxable years ending with the taxable year immediately prior to Utility's first taxable year ending on or after July 11, 2005, must follow the automatic change in accounting method provisions of Rev. Proc. 2002-9 (or its successor), with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply;

(2) The Utility must prepare a Form 3115 in accordance with section 6 of Rev. Proc. 2002-9 and must enter the designated number for the automatic change in method in Line 1a of Form 3115 (the designated number for the automatic accounting method change to the safe harbor method provided in section 5.01 of this revenue procedure is "91"); and

(3) The timely duplicate filing requirements of section 6.02(3) of Rev. Proc. 2002-9 do not apply; in lieu of such requirements, the Utility must:

(a) attach a completed Form 3115 to an amended return for the year of change, and must file, on or before December 31, 2005, that amended return and amended returns

for all subsequent affected taxable years, if any; and

(b) file a copy of the Form 3115 with the IRS National Office no later than when the original Form 3115 is filed with the amended return.

In accordance with § 1.446-1(e)(3)(ii) and Rev. Rul. 90-38, a Utility complying with the provisions of this section 6.03 is hereby granted consent to make a retroactive change in method of accounting to the safe harbor method provided in section 5.01 of this revenue procedure.

SECTION 7. AUDIT PROTECTION

.01 If a Utility uses the safe harbor method provided in section 5.01 of this revenue procedure for Up-front Payments and does not deduct its reimbursements of the Up-front Payments, the method of accounting for an Up-front Payment will not be raised as an issue by the IRS in a taxable year that ends on or before July 11, 2005, provided the Up-front Payment was made pursuant to an Interconnection Agreement that satisfies all of the conditions of either section 5.02 or 5.03 of this revenue procedure, whichever is applicable. Also, if a Utility uses the safe harbor method provided in section 5.01 of this revenue procedure for Up-front Payments and does not deduct its reimbursements of the Up-front Payments, and its use of that method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) in examination, before an appeals

office, or before the U.S. Tax Court for any taxable year that ends on or before July 11, 2005, that issue will not be further pursued by the IRS, provided that the conditions in either section 5.02 or 5.03 of this revenue procedure, whichever is applicable, are satisfied.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this automatic change in the APPENDIX.

SECTION 9. DRAFTING INFORMATION

The principal author of this revenue procedure is David B. Silber of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure, contact Mr. Silber at (202) 622-3930 (not a toll-free call).