nationalgrid

Raquel J. Webster
Senior Counsel

October 19, 2016

BY HAND DELIVERY AND ELECTRONIC MAIL

Luly E. Massaro, Commission Clerk
Rhode Island Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

RE: Docket 4483 – Wind Energy Development, LLC (WED) and ACP Land, LLC Petition for Dispute Resolution Relating to Interconnection
Response to WED and ACP Land, LLC's Objection Dated October 14, 2016

Dear Ms. Massaro:

On behalf of National Grid, I write in response to the objection filed by Wind Energy Development, LLC and ACP Land, LLC (Petitioners) on October 14, 2014 in the above-referenced docket (Objection). In response to the Company's October 13, 2016 letter in this docket, Petitioners request that the PUC order the Company to "amend its interconnection tariff to provide instruction on how renewable energy developers can apply and qualify for this safe-harbor." Objection at p. 4. This request ignores the Company's position and the analysis of the Company's expert advisors, which the Company detailed in its October 13 letter.

Contrary to Petitioners' claims, Notice 2016-36 (New Notice) does not expand the existing IRS "safe harbor" to include interconnection with distribution. The New Notice only expands the IRS "safe harbor" for certain transmission system improvements. First, it expands the safe harbor to include interconnections between an electric transmission system and an energy storage facility. Previously, only generator interconnections with electric transmission systems were included in the "safe harbor."

The New Notice also expands the safe harbor to include generator reimbursements of transmission system upgrades required to facilitate the generator's interconnection with a different system. Previously, these transmission system upgrades were not included within the "safe harbor" because the generator would not have an interconnection agreement with a system with which it was not actually interconnecting. The parenthetical language in Section III of the New Notice only specifies that these transmission system upgrades are also eligible for the safe harbor if the other system with which the generator is interconnecting is a distribution system. Contrary to the Petitioner's claims, that parenthetical language does not expand the "safe harbor" to include the distribution system interconnection itself because it cannot meet the requirements of Section III C of the Notice, all of which require the relevant equipment to be used in transmission. Furthermore, nothing in either the Company's comments to David Selig or in the

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Edison Electric Institute (EEI) comments can be validly used to support the Petitioners' assertion that National Grid and EEI have concluded that the text of the New Notice includes distribution system interconnections within its "safe harbor." *See* Objection at p. 3. To the contrary, the Company's comments and EEI's comments clearly outline changes National Grid and EEI believe are required in the New Notice before such a conclusion can be made.

To support their flawed arguments, Petitioners also continue to refer to comments from the author of the New Notice, David Selig. The Company reiterates that Mr. Selig's comments are not binding on the IRS, and the only legal authority on the tax issue is the text of the New Notice. As the Company noted in its October 13, 2016 letter, as the taxpayer, the Company must use its own best judgment regarding whether DG Interconnections are taxable because it will be responsible for paying federal taxes on these transactions. It is the Company's position that distribution interconnections are not covered by the "safe harbor" under the New Notice. In the event that the IRS updates the New Notice as the Company and EEI have requested to make it clear that DG Interconnections are covered by the "safe harbor", the Company will re-assess its position.

In its Objection, Petitioners also object to the Company's request for confidential treatment of the Ernst & Young Opinion, which the Company filed with its October 13 letter in this docket. Notably, the Company intended to share the contents of the Ernst & Young Opinion with the parties in this docket, including Petitioners, and only intended to protect the Opinion from public disclosure. Although the Company does not agree with Petitioners' arguments regarding whether the Ernst & Young Opinion is confidential, given the significance of this issue for other customers affected by the New Notice, the Company withdraws its Motion for Protective Treatment of the Ernst & Young Opinion. The Company has, therefore, enclosed an un-redacted version of the Ernst & Young Opinion with this letter. *See* Attachment A.

Thank you for your attention to this matter. If you have any questions, please contact me at 781-907-2121.

Very truly yours,

Raquel J. Webster

Enclosure

cc: Docket 4483 Service List
Leo Wold, Esq.
Steve Scialabba, Division

Certificate of Service

I hereby certify that a copy of the cover letter and any materials accompanying this certificate was electronically transmitted to the individuals listed below.

The paper copies of this filing are being hand delivered to the Rhode Island Public Utilities Commission and to the Rhode Island Division of Public Utilities and Carriers.

___________________________________ October 19, 2016
Joanne M. Scanlon Date

Docket No. 4483 – Wind Energy Development LLC & ACP Land, LLC – Petition for Dispute Resolution Relating to Interconnection
Service List updated 6/13/16

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Tax Advisor/Client Communication
Privileged and Confidential

To: Donald Simpson
Group Head of Tax
National Grid

Robert A. Ermanski
Director, U.S. Tax Research & Planning
National Grid

From: Ernst & Young LLP

Date: 30 September 2016

National Grid – Application of Notice 2016-36 Analysis

I. SCOPE

National Grid North America Inc. ("National Grid" or the "Company") has requested the opinion (the "Opinion") of Ernst & Young LLP ("E&Y") regarding the application of Notice 2016-36 and its "safe harbor" to the interconnection of an electricity generation or cogeneration facility (the "Facility") with an electric distribution system that National Grid owns and operates (hereinafter referred to as the "Project").

The opinions expressed herein address the specific U.S. federal income tax effects associated with the specific issue as posed in the "Issue" section of this Opinion detailed below. You have not requested us to consider, and we have not considered, any other U.S. federal income tax consequences; any non-income tax consequences; or any state, local, or foreign income tax consequences in this Opinion. Accordingly, we do not express any opinion on any other U.S. federal income tax; non-income tax; or state, local, or foreign tax issues. Furthermore, we express no opinion on non-tax issues, such as corporate law or securities law matters. We express no opinion other than as stated herein, and neither this opinion nor any prior statements are intended to imply or to be an opinion on any other matters.

With respect to any significant federal tax issues outside the limited scope of this Opinion, our advice was not written, and cannot be used by the recipient, for any purpose including for the purpose of avoiding penalties that may be imposed on the recipient.

II. FACTS

A. Company Overview

National Grid is the common parent of an affiliated group of corporations. The Company's core business is the transmission and distribution of electricity in New York and New England. National Grid also has subsidiaries engaged in the generation of electricity, natural gas distribution, construction, and other businesses. The Company is a subsidiary of National Grid, plc, an international energy delivery business based in the United Kingdom with its principal activities in the regulated electric and gas industries.

B. Project Background

For purposes of this Opinion, the Company represents the following:

(1) National Grid will construct an intertie connecting a third party electric generation or co-generation facility (hereinafter referred to as the "Facility") to its distribution system, and the Facility will reimburse National Grid for the related construction costs.
(2) The intertie will consist solely of new connecting facilities needed to connect the Facility to the National Grid distribution system. It will not consist of any facilities connecting the Facility with any transmission system, but transmission system upgrades may be required in certain cases to accommodate some of these distribution system interconnections.
(3) The Facility will provide an engineering report showing that it is expected to satisfy the 5% test (as defined in Section IV below).
(4) The Facility will sell generated electricity to National Grid or another purchaser, and title to the electricity will pass at the busbar on the Facility's side of the intertie.
(5) The cost of the related intertie will not be included in National Grid's rate base.
(6) The intertie will be used solely for the distribution of electricity, and none of the power passing through the intertie will be transmitted on any transmission system.
(7) The Facility will capitalize the construction costs and amortize them over 20 years under the straight line method.
(8) National Grid will not claim depreciation or amortization deductions with respect to the intertie for U.S. federal income tax purposes.

III. ISSUE

Whether payments by the Facility to National Grid for the construction of an Intertie connecting the Facility to the Company's distribution system are subject to the safe harbor provisions of Notice 2016-36?

IV. LAW

A. Section 118(a)

Section 61(a)[1] and Treas. Reg. § 1.61-1 provide that gross income means all income from whatever source derived, unless excluded by law. Section 118(a) provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Section 118(b) provides that for purposes of subsection (a), except as provided in subsection (c), the term "contribution to the capital of taxpayer" does not include any contribution in aid of construction ("CIAC") or any other contribution as a customer or potential customer.

The regulations to section 118 clarify that the section applies to non-shareholder contributions as well as to shareholder contributions.[2] For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of enabling the corporation to expand its operating facilities.[3] The exclusion does not, however, apply to any money or property transferred to the corporation in consideration for goods and services rendered or to subsidies paid to induce the taxpayer to limit production.[4]

The legislative history with respect to section 118 indicates that the exclusion from gross income for non-shareholder contributions to capital of a corporation was intended to apply to those contributions that cannot be considered gifts, because the contributor expects to derive indirect benefits, or payments for future services, because the anticipated future benefits are too intangible. The legislative history also indicates that the provision was intended to codify the existing law that had developed through administrative and court decisions on the subject.[5]

The amendment of section 118(b) by Section 824(a) of the Tax Reform Act of 1986 ("the 1986 Act") was intended to require utilities to include in income the value of any CIAC made to encourage the provision of services by a utility to a customer.[6] The Joint Committee on Taxation explained that Congress intended that the effect of the change was to require that a utility report as an item of gross income the value of any property, including money, that it receives to provide, or encourage the provision of,

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[1] Unless otherwise stated, references to the Internal Revenue Code, or "Code" or "IRC," are to the Internal Revenue Code of 1986, as amended, and all references to the "regulations" or to "Treas. Reg." are to the Treasury Regulations promulgated thereunder. Unless otherwise stated, all references to "section," "sections," and "§" are to sections of the Code or regulations.

[2] Treas. Reg. §1.118-1.

[3] *Id.*

[4] *Id*.

[5] *See*, H.R. Rep. No. 1337, at 17 (1954); S. Rep. No. 1622, at 18-19 (1954).

[6] *See*, H.R. Conf. Rep. No. 99-841, at 324 (1986).

services to or for the benefit of the person transferring the property. A utility is deemed to receive property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of the services, if the receipt of the property results in the provision of services earlier than would have been the case had the property not been received, or if the receipt of the property otherwise causes the transferor to be favored in any way.[7]

B. Notice 88-129

Notice 88-129,[8] (as later modified and amended by Notice 90-60,[9] and Notice 2001-82[10]) provides specific guidance with respect to the treatment of transfers of property to regulated public utilities by qualifying small power producers and qualifying co-generators (collectively, "Qualifying Facilities"[11]). Notice 88-129 states that in a CIAC transaction the purpose of the contribution of property to the utility is to facilitate the sale of power by the utility to a customer. In contrast, the purpose of the contribution by a Qualifying Facility to a utility is to permit the sale of power by the Qualifying Facility to the utility. Accordingly, Notice 88-129 concludes that the fact that the 1986 amendments to section 118(b) render CIAC transactions taxable to the utility does not require a similar conclusion with respect to transfers from Qualifying Facilities to utilities.

Notice 88-129 provides a safe harbor under section 118 for certain transfers of interties by a Qualifying Facility to a regulated public utility. The safe harbor provides, in part, that with respect to transfers made by a Qualifying Facility to a utility exclusively in connection with the Qualifying Facility's sale of electricity to the utility, a utility will not realize income upon transfer of an intertie by a Qualifying Facility. An intertie may include new connecting and transmission facilities or modifications, upgrades, or relocations of a utility's existing transmission network. The possibility that an intertie may be used to transmit power to a utility that will in turn transmit the power across its transmission network for sale by the Qualifying Facility to another utility (i.e., wheeling) will not cause the contribution to be treated as a CIAC.

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[7] General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Cong., 2nd Sess. 545 (May 4, 1987).

[8] 1988-2 C.B. 541.

[9] 1990-2 C.B. 345. Note that Notice 90-60 modified and amplified section 4 of Notice 88-129 (detailing the amount to be included in income by the utility as a CIAC upon a "disqualification event" as detailed in Notice 88-129 as well as the treatment of an intertie contribution upon the termination of a power purchase contract) and amended section 6 of Notice 88-129 (removing the words "as a CIAC" from said section of Notice 88-129). Accordingly, Notice 90-60 is not relevant and therefore is not discussed in further detail in this Opinion.

[10] 2001-2 C.B. 619 (2001).

[11] As defined in section 3 of the Federal Power Act, as amended by section 201 of the Public Utilities Regulatory Policies Act of 1978 ("PURPA").

Further, Notice 88-129 provides, in part, that a transfer from a Qualifying Facility to a utility will not be treated as a Qualifying Facility transfer ("QF Transfer") under this notice to the extent that the intertie is included in the utility's rate base. Moreover, a transfer of an intertie to a utility will not be treated as a QF Transfer under this notice if the term of the power purchase contract is less than ten years.

Notice 88-129 also provides, in part, that a utility that constructs an intertie in exchange for a cash payment from a Qualifying Facility pursuant to a PURPA contract will be deemed to construct the property under contract and will recognize income from the construction in the same manner as any other taxpayer constructing similar property under contract. However, subsequent to the construction of the intertie, the Qualifying Facility will be deemed to transfer the intertie to the utility in a QF transfer that is treated in exactly the same manner as an in-kind QF transfer.

In addition, Notice 88-129 provides, in part, that the contribution of a dual-use intertie to a utility will be treated as a QF Transfer (and, therefore, nontaxable) if, in light of all information available to the utility at the time of transfer, it is reasonably projected that during the first ten taxable years of the utility, beginning with the year in which the transferred property is placed in service, no more than five percent of the projected total power that flows over the intertie will flow to the Qualifying Facility (the "5% test").

Thus, Notice 88-129 established a safe harbor that, if met, rendered such interconnection contributions non-taxable under Section 118.

C. Notice 2001-82

Notice 2001-82 amplifies and modifies Notice 88-129. Notice 2001-82 extends the safe harbor provisions of Notice 88-129 to include transfers of interties from non-Qualifying Facilities and transfers of interties used exclusively or in part to transmit power over the utility's transmission grid for sale to consumers or intermediaries (i.e., wheeling). The notice requires that ownership of the electricity wheeled passes to the purchaser prior to its transmission on the utility's transmission grid. Further, Notice 2001-82 provides that a long-term interconnection agreement in lieu of a long-term power purchase contract may be used to satisfy the safe harbor provisions of Notice 88-129 in wheeling transactions. Finally, Notice 2001-82 requires that the generator must capitalize the cost of the property transferred as an intangible asset and recover that cost using the straight-line method over a useful life of twenty years.

D. Notice 2016-36

In June 2016, the IRS issued Notice 2016-36[12] which modifies and supersedes Notice 88-129, Notice 90-60, and Notice 2001-82. Notice 2016-36 consolidates the safe

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[12] 2016-25 I.R.B. 1029 (2016).

harbor requirements under the previous Notices, removes the requirement for a long-term purchase power contract or a long-term interconnection agreement, and extends the safe harbor to transfers of interties from energy storage facilities to regulated public utilities. In sum, Notice 2016-36 "…provides a safe harbor for transfers of property from either an electricity generation or cogeneration facility or an energy storage facility to a regulated public utility, used to facilitate the transmission of electricity over the utility's transmission system, to be treated as a contribution to the capital of a corporation under § 118 (a), and not a…CIAC under § 118 (b)."

Under the safe harbor in Notice 2016-36, a contribution of an intertie by a generator to a utility will not be treated as a CIAC under section 118(b) if all of the following conditions are met:

(1) The generator may not purchase electricity from a utility, unless the purchase satisfies the 5% test;
(2) Ownership of wheeled electricity must remain with the generator before transmission onto the grid. The ownership requirement is deemed satisfied if title to electricity wheeled passes to the purchaser at the busbar on the generator's end of the intertie;
(3) The intertie cost is not included in the utility's rate base;
(4) The intertie will be used for transmitting electricity; and
(5) The generator capitalizes the intertie cost as an intangible asset and recovers the cost using the straight-line method over a 20 year useful life.[13]

Notice 2016-36 provides the current safe harbor in place dictating scenarios in which transfers of property from an electric generation or cogeneration facility (or an energy storage facility) will be treated as a contribution to the capital of a regulated public utility under section 118(a) as opposed to a taxable CIAC under section 118(b).

E. Construction of Tax Authority

The Internal Revenue Code is subject to strict construction and must be construed from the language employed within its four corners.[14] Similarly, provisions that provide exemptions from taxation are to be strictly construed.[15]

The Internal Revenue Service (the "IRS" or the "Service") has administrative authority to promulgate guidance regarding interpretation of the Internal Revenue Code. A "Notice" (such as the Notice 88-129, Notice 90-60, Notice 2001-82, and Notice 2016-36 discussed herein) is a public pronouncement issued by the IRS that may contain

[13] Notice 2016-36 also provides specified events that, if incurred, will terminate the application of the safe harbor. These events are not discussed in detail within this Opinion.
[14] *See, e.g., United States v. Merriam*, 263 U.S. 179 (1923) ("…in statutes levying taxes the literal meaning of the words employed is most important, for such statutes are not to be extended by implication beyond the clear import of the language used.").
[15] *Helvering v. Northwest Steel Rolling Mills Inc.*, 311 U.S. 46 (1940).

guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law.[16]

V. ANALYSIS

Notice 2016-36, as discussed in detail above, helps address the statutory ambiguity in section 118 by providing an exemption from Federal income taxation (i.e., by treating certain transfers of property to a regulated public utility as a contribution to capital under section 118(a) as opposed to a CIAC under section 118(b)) via a safe harbor. As such, the safe harbor provided in Notice 2016-36 must be strictly construed.

Utilizing a strict construction of the guidance, Notice 2016-36 focuses on transfers of property to a regulated public utility for use in the utility's transmission system. Specifically, as referenced above, the purpose of Notice 2016-36 (as set forth in Section I.) is as follows:

> This notice provides a safe harbor for transfers of property from either an electricity generation or cogeneration facility or an energy storage facility to a regulated public utility, ***used to facilitate the transmission of electricity over the utility's transmission system***, to be treated as a contribution to the capital of a corporation under §118(a), and not a contribution in aid of construction (CIAC) under §118(b). (Emphasis added).

Further, Section III. C. of Notice 2016-36 provides that the safe harbor only applies to the contribution of an "intertie" (as defined in Section III. B. of Notice 2016-36) that satisfies certain requirements. Section III. B. of Rev. Proc. 2016-36 defines the term "intertie" exclusively in terms of transmission equipment as set forth below:

> An intertie includes new connecting and ***transmission facilities***, or modifications, upgrades, or relocations of a utility's existing ***transmission network*** that enable or facilitate the interconnection of a generator with a utility or improve efficiency on the utility's ***transmission network***. (Emphasis added).

Finally, in looking at the specific requirements for applicability of the safe harbor (via Section III. C. of Notice 2016-36), the second requirement provides that, "[i]n the case of electricity wheeled over the utility's ***transmission system***, ownership of the wheeled electricity remains with the generator prior to its transmission onto the grid." (Emphasis added). In addition, the fourth requirement provides that, "***[t]he intertie will be used for transmitting electricity***." (Emphasis added).

Under Notice 88-129 and Notice 2001-82, the safe harbor applied to the contribution of equipment interconnecting generator facilities with utility transmission systems.

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[16] https://www.irs.gov/uac/understanding-irs-guidance-a-brief-primer (last accessed Sep. 22, 2016).

However, uncertainty existed as to whether distribution systems would be treated as meeting the safe harbor which resulted in a couple of Private Letter Ruling requests that concluded differently on the application to distribution systems.[17] This highlights the remaining uncertainty with the appropriate tax treatment of contributions of distribution interties and the need for a fact based inquiry and analysis.

The "Explanation of Provisions" in Section III. A. of Notice 2016-36 did indicate a possible change with respect to the treatment of distribution systems where it states:

> 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 <u>a distribution system</u>, rather than a transmission system, if all of the requirements under section III.C of this notice are met." (Emphasis added).

However, as outlined above, the "Purpose" and "Requirements" of the safe harbor as described in Section I and Section III. C. of Notice 2016-36, respectively, make no reference to distribution systems. The specific requirements of the safe harbor refer exclusively to transmission systems, creating uncertainty regarding the treatment of a distribution facility and highlighting that the IRS failed to specifically include distribution systems when they had the opportunity to make the treatment of distribution systems very clear if specifically included within the safe harbor.

Based on the discussion above, strict construction of Notice 2016-36 dictates that the use of the safe harbor set forth in such notice is limited to transfers of property to a regulated public utility that are then used by such utility to facilitate the transmission of electricity over the utility's transmission system. Although it is possible to take a position that transfers of similar property that do not meet the specific conditions in Notice 2016-36 may be excluded from income as a contribution to capital, such a position would rely on the statutory provisions of § 118, and the associated regulations and case law. Such an analysis would require inquiry into the contributor motivation and intent and, based on the current state of the law, there is a degree of subjectivity and uncertainty in any technical analysis that applies facts and circumstances to how the law applies. Therefore, although it is possible a compelling

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[17] *See, e.g.* PLR 201619007 (05/06/2016) (IRS ruled that the transfer of the interconnection was taxable because "there was no direct interconnection between the Facility and an electric transmission system) and also PLR 201122005 (03/03/2011) (IRS ruled that the deemed contribution of the intertie to the taxpayer's distribution system by Generator to Taxpayer meets the safe harbor requirements of Notice 88-129, as amended and modified by Notice 90-60 and Notice 2001-82. However, the facts were significantly redacted in the PLR and it is unclear the facts upon which the ruling was based.)

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position could be developed, it would lack the certainty provided by the safe harbor in Notice 2016-36 for fact patterns falling within the specific, delineated scope of the safe harbor.

VI. CONCLUSION

While the matter is not free from doubt, this advice represents our professional judgment that the positions described herein ***should*** prevail on the merits if the matter were in controversy before the applicable jurisdiction's highest court:

Payments made by the Facility to National Grid to construct an intertie connecting the Facility to the Company's distribution system do not meet the requirements of the safe harbor set forth in Section III. C of Notice 2016-36.

VII. PENALTY AND DISCLOSURE DISCUSSION

If it is determined that a taxpayer has understated its federal income tax liabilities, it may be subject to one of several accuracy-related penalties imposed by the Code. Our advice and conclusions, regardless of the level of confidence, do not prevent the IRS from disagreeing with the reporting positions supported by our stated conclusions, proposing a tax deficiency, and asserting an accuracy-related penalty.

This section addresses penalties that could be applicable to the issues addressed herein if the IRS were to disagree with the reporting positions supported by our stated conclusions and propose tax deficiencies. Based on our understanding of the facts and your representations, the issues addressed do not appear to relate to a reportable transaction pursuant to Treas. Reg. §1.6011-4 and, accordingly, the disclosure obligations and penalties related to reportable transactions are not discussed.

A. Accuracy-Related Penalties

Section 6662 imposes a penalty equal to 20% of any underpayment of tax attributable to (i) negligence – a failure to make a reasonable attempt to comply with the provisions of the internal revenue laws, (ii) careless, reckless, or intentional disregard of the Code, a temporary or final regulation, a revenue ruling, or an IRS notice, (iii) a substantial understatement of income tax, or (iv) any disallowance of claimed tax benefits by reason of a transaction lacking economic substance or failing to meet the requirements of any similar rule of law.

The first two categories of accuracy-related penalties should not be applicable to the items addressed herein, because the conclusions reached herein are at a more-likely-than-not level of confidence based upon the applicable Code provisions, regulations, and guidance that have been considered and applied to the analysis.[18] With respect to the third category listed above, there is a substantial understatement of income tax for any taxable year if the amount of the understatement exceeds the lesser of (1) 10% of the tax required to be shown on the return for the taxable year or, if greater, $10,000, or (2) $10 million.[19] Unless an item is attributable to a "tax shelter,"[20] the amount of any understatement of income tax is reduced for that portion of the understatement that is attributable to either (1) a position for which there is substantial authority or (2) an item for which there is reasonable basis and adequate disclosure in the tax return.[21] Thus, if there is substantial authority, or a higher level of authority, adequate disclosure is not required to avoid the penalty.[22]

These reductions to the amount of any understatement do not apply to any item attributable to a "tax shelter" as defined in section 6662(d)(2)(C): a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. The term "significant purpose" is not defined in the Code, regulations, or other guidance, but one court has held that such transactions could include legitimate attempts by a company to reduce its tax burden.[23] Therefore, when a taxpayer takes pro-active steps to plan and implement a transaction with a view to reduce its tax burden, our recommended approach is to consider that the IRS may regard the transaction as having a significant purpose of tax avoidance. Based on the facts reviewed and your representations, it is our view that the IRS should not conclude that the issues discussed herein relate to a "significant purpose" transaction.

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[18] Moreover, the conclusions reached herein are at a level of confidence necessary to establish a "reasonable cause" defense to an accuracy-related penalty based on negligence or disregard of a rule or a regulation under Treas. Reg. §1.6664-4(c).

[19] Section 6662(d)(1)(B)(i) and (ii). For non-corporate taxpayers, an understatement of income is substantial if the understatement exceeds the greater of: (1) 10% of the tax required to be shown on the return for the taxable year, or (2) $5,000. Section 6662(d)(1)(A)(i) and (ii). An "understatement" means the excess of the amount required to be shown on the return for the taxable year over the amount of tax imposed which is shown on the return, reduced by any rebate. Section 6662(d)(2)(A)(i) and (ii).

[20] A "tax shelter" is defined in section 6662(d)(2)(C) as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. The term "significant purpose" is not defined in the Code, regulations, or other guidance, but one court has held that such transactions could include legitimate attempts by a company to reduce its tax burden. *See*, *Valero Energy Corp. v. United States*, 569 F.3d 626 (7th Cir. 2009).

[21] Section 6662(d)(2)(B). The method for making adequate disclosure is set forth in Treas. Reg. §1.6662-4(f).

[22] Treas. Reg. §1.6662-4(a).

[23] *Valero Energy Corp. v. United States*, 569 F.3d 626 (7th Cir. 2009).

As for the fourth category listed above, a transaction has economic substance if (1) the transaction changes the taxpayer's economic position in a meaningful way, apart from the federal income tax effects, and (2) the taxpayer has a substantial purpose for entering into the transaction that is apart from the federal income tax effects.[24] The penalty amount is 40 percent of the underpayment attributable to any portion of a transaction lacking economic substance (or failing to meet the requirements of any similar rule of law) that was not adequately disclosed and 20 percent if adequate disclosure is made.[25] A reasonable cause defense against the assertion of a penalty for lack of economic substance is not available.[26]

B. Reasonable Cause Defense to Accuracy-Related Penalty

Other than a penalty with respect to a transaction lacking economic substance or failing to meet the requirements of any similar rule of law,[27] no penalty may be imposed under Section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion.[28] Whether reasonable cause and good faith exists is decided on a case-by-case basis, considering all the pertinent facts and circumstances.[29] Except in connection with an item attributable to a "tax shelter," actual reliance on advice of a professional can establish reasonable cause and good faith when the advice (i) is based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances, and (ii) is not based on unreasonable factual or legal assumptions and does not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or others.[30]

The advice and conclusions provided herein are based on all pertinent facts and circumstances known to us and the representations and assumptions set forth above (which in our view are reasonable). Additionally, as expressed above, E&Y has concluded, based on our understanding of the facts and your representations, that the tax treatment for the issues addressed herein is at a more-likely-than-not level of confidence. Accordingly, it is our view that National Grid should be able to rely on this Opinion for purposes of establishing a reasonable belief that the tax treatment outlined in this Opinion was the proper treatment.

VIII. CAVEATS AND OTHER LIMITATIONS

[24] Section 7701(o).
[25] Section 6662(i).
[26] Section 6664(a).
[27] Section 6664(c)(2),.
[28] Treas. Reg. §1.6664-4(a)
[29] Treas. Reg. § 1.6664-4(b).
[30] Treas. Reg. § 1.6664-4(c).

In rendering this Opinion, we have relied upon the accuracy and completeness of the facts, assumptions, and representations (without regard to any limitation based on knowledge or belief, or any similar limitation) provided to us by the Company. National Grid has represented, on behalf of itself and its affiliates, that such facts, assumptions, and representations are true, correct, and complete. However, we have not independently audited or otherwise verified any of these facts, assumptions, or representations. A misstatement or omission of any fact or a change or amendment in any of the facts, assumptions, or representations we have relied upon may require a modification of all or a part of this Opinion. In addition, this Opinion is based on such facts, assumptions, and representations as represented to us as of the date of this letter. Any changes in the facts, assumptions, or representations upon which we have relied may require a modification of all or part of this Opinion. We have no responsibility to update this Opinion for events, circumstances, or changes in any of the facts, assumptions, or representations occurring after this date.

The opinions herein are based upon our interpretation of the Code, U.S. Treasury regulations promulgated thereunder, court decisions, rulings and procedures issued by the Service, and such other authorities as we deemed relevant, in each case as of the date of this Opinion. U.S. federal income tax laws and regulations, and the interpretations thereof, are subject to change, which could adversely affect this Opinion. Should there be any change, including any change having retroactive effect, in the Code, the regulations thereunder, and the administrative guidance issued thereunder, or in the prevailing judicial interpretation of the foregoing, the opinions expressed herein would necessarily have to be reevaluated in light of such change. The opinions expressed herein are as of the date of this letter, and we have no responsibility to update this Opinion for changes in applicable law or authorities occurring after the date of this Opinion.

This Opinion represents our opinions only and should not be taken as an assurance of the ultimate tax treatment. This Opinion is not binding on the Service, and there can be no assurance that the Service would not take positions contrary to the opinions set forth herein and would not be successful in sustaining such contrary positions. However, should the Service challenge the U.S. federal income tax treatment of the Project, this Opinion reflects our assessment of the merits.

E&Y expressly authorizes National Grid (and each employee, representative, or other agent thereof) to disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the Project and all materials of any kind (including tax analyses) that are provided to National Grid relating to such tax treatment and tax structure. This Opinion, however, is solely for the benefit of National Grid for the purpose of assessing the issue set forth in the Issue section detailed above and is not to be relied upon by anyone else without the written consent of E&Y. We assume no responsibility for tax consequences, or any other consequences, to any other parties to the Project or to other persons. Instead, any other such parties or persons should consult and rely upon the advice of their own counsel, accountant, tax advisor or other advisors.