**Internal Revenue Service**

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**Department of the Treasury**

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## LEGEND

Taxpayer =

Parent =

Transferor =

Substation 1 =

Substation 2 =

State =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 1 =

b =

c =

d =

e =

f =

g =

Dear :

This letter responds to your letter dated July 10, 2002, and subsequent correspondence, submitted on behalf of Taxpayer, requesting a letter ruling concerning whether the transfer of an intertie by Transferor to Taxpayer will be a nonshareholder contribution to capital excludable from income under § 118(a) of the Internal Revenue Code.

Taxpayer represents that the facts are as follows:

## FACTS

Taxpayer is an investor-owned utility organized under State law that supplies electricity to various parts of State. Taxpayer owns and operates an integrated transmission system for the transmission of electrical energy generated by itself as well as other generating utilities. Taxpayer is a member of the Parent affiliated group of corporations.

Parent is a global energy company that is engaged, through various subsidiaries, in electricity generation, distribution, and trading and related services. Parent owns, manages, or has an interest in power plants in the United States and abroad and serves as a holding company for utilities in various states. Parent files a consolidated federal income tax return for all members of the affiliated group, including Taxpayer. The affiliated group reports its income using a calendar tax year and the accrual method of accounting.

Transferor is a rural electric cooperative in State. Transferor was organized in Year 1 and is exempt from federal income tax under § 501(c)(12). Transferor is a generation and transmission cooperative.

Under the terms of the Year 2 Interconnection Agreement (IA) between Transferor and Taxpayer, Transferor must utilize Taxpayer's transmission grid for the wheeling of power in order to sell any portion of its generation in the Off-System Area. The wheeling of Transferor's sales of electric power across Taxpayer's transmission system are governed under the terms of the Interconnection Agreement. This agreement addresses the terms and conditions of such sales as well as the applicable tariff for each type of transaction. Because Transferor has the responsibility to provide generation for its members in the Off-System Area, a location that is generally in Taxpayer's service territory, load and generation must be balanced between Transferor and Taxpayer and their respective service areas to allow for service during contingencies. This situation requires the installation of generation facilities by Transferor in the On-System as well as the Off-System Area.

In order to better serve its members in the Off-System Area, facilitate its members' economic development efforts and provide generation to balance its generation with load in the On-System and Off-System areas and Taxpayer's transmission system, Transferor is planning to construct a new generation site approximately b miles east of Substation 1. Criteria for selection of this site included access to high-pressure natural gas service, the existence of a stream into which wastewater could be discharged, access to existing Transferor and Taxpayer transmission lines, and availability of water. The existing Transferor transmission lines are radial in nature and serve discrete member loads. Substation 1 site is landlocked within an existing service territory of one of Transferor's members and is adjacent to an area served by Taxpayer. Accordingly, the proposed generator units will not be physically attached to or part of any other generating facility owned or operated by Transferor. In addition to fostering economic development, the Substation 1 site was chosen by Transferor to eliminate a recurring energy imbalance that creates inefficiencies in the integrated transmission systems of Taxpayer and Transferor. Elimination of this energy unbalance will result in more efficient operation of the transmission system, reduced transmission cost to Transferor, improved reliability of Substation 1, and improved operation of the entire Taxpayer transmission grid.

Transferor will construct a total of b c-MW gas-fired combustion turbines on the site (Facilities). Construction on the first unit is commencing in Year 3 with the final unit scheduled to be completed by the summer of Year 4. The Facilities are being constructed primarily to meet the electrical demand of Transferor's members in the Off-System Area during times of peak usage. Accordingly, these Facilities may be idle for extended periods of time until needed. Transferor may also use these Facilities to make sales at wholesale to other utilities, including Taxpayer.

Taxpayer represents that the intertie (Intertie) includes the following, with the exception of Substation 2. In order to make the Facilities fully functional, Transferor will build d e kV lines from the generating site to the vicinity of Substation 1. Adjacent to Substation 1, Transferor will construct Substation 2, a new e kV substation that will serve as the terminus for these new transmission lines. Transferor will also relocate d existing transmission lines, which are currently served by Substation 1, to the new Substation 2. Transferor will construct Substation 2 to Taxpayer's specifications and will lease Substation 2 to Taxpayer which will operate and maintain the new site for Transferor. Several (d) of Taxpayer's existing e kV transmission lines will also be relocated to the new Substation 2. Taxpayer employees will be used to do the work and Transferor will pay for the relocation costs. Upon completion, Substation 2 will be interconnected with the Substation 1. Transferor will pay for the cost to make the interconnection. Additionally, Taxpayer must upgrade system protection devices on the d existing Taxpayer e kV transmission lines prior to the reconnection of these lines to Substation 2.

On Date 1, Transferor and Taxpayer executed a Memorandum of Understanding (MOU) relating to the implementation and administration of the Year 3 Interconnection Operating Agreement (IOA) applicable solely to the Facilities. According to the MOU,

the IOA is intended by the parties as a complimentary but stand-alone addendum to, and not as a substitute or replacement of, the IA. The parties intend that the IOA be effective only as to the interconnection and interconnected operation of the Facilities.

Although Taxpayer has yet to determine a final cost estimate, the costs charged to Transferor for completion of the Intertie may total between $f and $g. Taxpayer will not include the costs of the Intertie in its rate base.

Taxpayer makes the following additional representations. First, the Intertie will become a permanent part of Taxpayer's working capital structure. Second, the transfer of the Intertie by Transferor to Taxpayer will not be compensation for a specific, quantifiable service provided by Taxpayer. Third, the proposed transfer of the Intertie was subject to negotiations between Transferor and Taxpayer, and consequently, the transfer was bargained for. Fourth, the Intertie will foreseeably benefit Taxpayer in an amount commensurate with its value for the reasons stated above regarding the benefits that Taxpayer will derive from the more efficient operation of its transmission grid in this area. Fifth, the Intertie will be employed in or contribute to the production of additional income to Taxpayer, and consequently, the value of the Intertie will be assured in that respect.

Transferor represents that the costs for the Intertie contributed to Taxpayer by Transferor will be capitalized by Transferor as an intangible asset and recovered using a straight line method over a useful life of 20 years.

## RULING REQUESTED

Taxpayer requests the Service to rule that the transfer of the Intertie by Transferor to Taxpayer will not be a contribution in aid of construction under § 118(b), and will be excludable from Taxpayer's gross income as a nonshareholder contribution to capital under § 118(a).

## LAW AND ANALYSIS

Section 61(a) and § 1.61-1 of the Income Tax Regulations 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), as amended by § 824(a) of the Tax Reform Act of 1986 (the 1986 Act) and § 1613(a) of the Small Business Job Protection Act of 1996, 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 CIAC or any other contribution as a customer or potential customer.

Section 1.118-1 of the Income Tax Regulations provides, in part, that § 118 also applies to contributions to capital made by persons other than shareholders. 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. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid to induce the taxpayer to limit production.

The legislative history to § 118 indicates that the exclusion from gross income for nonshareholder contributions to capital of a corporation was intended to apply to those contributions that are neither gifts, because the contributor expects to derive indirect benefits, nor 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. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18-19 (1954).

Notice 88-129, 1988-2 C.B. 541, as modified and amended by Notice 90-60, 1990-2 C.B. 345, and Notice 2001-82, 2001-52 I.R.B. 619, provides specific guidance with respect to the treatment of transfers of property to regulated public utilities by qualifying small power producers and qualifying cogenerators (collectively, Qualifying Facilities), as defined in section 3 of the Federal Power Act, as amended by section 201 of PURPA.

The amendment of § 118(b) by the 1986 Act was intended to require utilities to include in income the value of any CIACs made to encourage the provision of services by a utility to a customer. See H.R. Rep. No. 841, 99th Cong., 2d Sess. 324 (1986). 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, the fact that the 1986 amendments to § 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, in part, that with respect to transfers made by a Qualifying Facility to a utility exclusively in connection with the sale of electricity by the Qualifying Facility to the utility, a utility will not realize income upon transfer of interconnection equipment (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 (wheeling) will not cause the contribution to be treated as a CIAC.

Further, the notice 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 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.

The notice 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. Subsequent to the construction of the property, the Qualifying facility will be deemed to transfer the property to the utility in a QF transfer that will be treated in exactly the same manner as an in-kind QF transfer.

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 (wheeling). The notice requires that ownership of the electricity wheeled passes to the purchaser prior to its transmission on the utility's transmission grid. This ownership requirement is deemed satisfied if title passes at the busbar on the generator's end of the intertie. 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 recovered using the straight-line method over a useful life of 20 years.

In the instant case, the proposed transfer of the Intertie will be subject to the guidance set forth in Notice 88-129, Notice 90-60, and Notice 2001-82 for the following reasons: (1) the Facilities will be a stand-alone generator as contemplated under Notice 2001-82; (2) Transferor and Taxpayer have entered into a long-term interconnection agreement; (3) the Intertie will be used in connection with the transmission of electricity primarily for sale to third parties (wheeling); (4) the cost of the Intertie will not be included in Taxpayer's rate base; (5) it is projected that during the first ten taxable years of the Facilities, no more than 5 percent of the projected total power flows over the Intertie will flow to Transferor; (6) it is represented that Transferor will not own the electricity prior to its transmission on Taxpayer's transmission grid; and (7) the cost of the Intertie will be capitalized by Transferor as an intangible asset and recovered using the straight-line method over a useful life of 20 years. Thus, we conclude that the transfer of the Intertie by Transferor to Taxpayer will meet the safe harbor requirements of Notice 88-129, as amended and modified by Notice 90-60 and Notice 2001-82.

Next, we must decide whether the contribution will qualify as a contribution to capital under § 118(a).

The legislative history of § 118 provides, in part, as follows:

This [§ 118] in effect places in the Code the court decisions on the subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the treating the contribution as a payment for future services.

S. Rep. No. 1622, 83d Cong., 2d Sess. 18-19 (1954).

In Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), the Court held that payments by prospective customers to an electric utility company to cover the cost of extending the utility's facilities to their homes, were part of the price of service rather than contributions to capital. The concerned customers' payments to a utility company for the estimated cost of constructing service facilities (primary power lines) that the utility company otherwise was not obligated to provide. The customers intended no contribution to the company's capital.

Later, in Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), 1950-1 C.B. 38, the Court held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned that when the motivation of the contributors is to benefit the community at large and the contributors do not anticipate any direct benefit from their contributions, the contributions are nonshareholder contributions to capital. Id. at 41.

Finally, in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 413 (1973), the Court, in determining whether a taxpayer was entitled to depreciate the cost of certain facilities that had been funded by the federal government, held that the governmental subsidies were not contributions to the taxpayer's capital. The court recognized that the holding in Detroit Edison Co. had been qualified by its decision in Brown Shoe Co. The Court in Chicago, Burlington & Quincy Railroad Co. found that the distinguishing characteristic between those two cases was the differing purpose motivating the respective transfers. In Brown Shoe Co., the only expectation of the contributors was that such contributions might prove advantageous to the community at large. Thus, in Brown Shoe Co., since the transfers were made with the purpose, not of receiving direct services or recompense, but only of obtaining advantage for the general community, the result was a contribution to capital.

The Court in Chicago, Burlington & Quincy Railroad Co. also stated that there were other characteristics of a nonshareholder contribution to capital implicit in Detroit Edison Co. and Brown Shoe Co. From these two cases, the Court distilled some of the characteristics of a nonshareholder contribution to capital under both the 1939 and 1954 Codes. First, the payment must become a permanent part of the transferee's working capital structure. Second, it may not be compensation, such as a direct

payment for a specific, quantifiable service provided for the transferor by the transferee. Third, it must be bargained for. Fourth, the asset transferred foreseeably must benefit the transferee in an amount commensurate with its value. Fifth, the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

The proposed transfer of the Intertie by Transferor to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the Intertie will become a permanent part of Taxpayer's working capital structure. Second, the Intertie is not compensation for a specific, quantifiable service provided by Taxpayer. Third, the proposed transfer of the Intertie was subject to negotiations between Transferor and Taxpayer, consequently, it was bargained for. Fourth, the Intertie will foreseeably benefit Taxpayer in an amount commensurate with its value for the reasons stated above regarding the benefits that Taxpayer will derive from the more efficient operation of the grid in this area. Fifth, the Intertie will be employed in or contribute to the production of additional income to Taxpayer and consequently, the value of the Intertie will be assured in that respect. Therefore, Taxpayer's receipt from Transferor of the Intertie will be a contribution to capital under § 118(a).

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer and Transferor, we rule that the transfer of the Intertie by Transferor to Taxpayer will not be a CIAC under § 118(b) and will be excludable from the gross income of Taxpayer as a nonshareholder contribution to capital under § 118(a).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations. Specifically, no opinion is expressed or implied as to whether your representation that less than 5 percent of the total projected power flows over the Intertie from Taxpayer to Transferor is a reasonable projection for purposes of the 5 percent test in Notice 88-129.

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

Sincerely,

Walter H. Woo
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Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy