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Department of the Treasury

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Date:
February 21,2003

LEGEND

Taxpayer =

State A =

Company A =

Service Center =

Division =

Generator =

State B =

Company B =

Company C =

Company D =

Facility =

Date 1 =

Date 2 =

a =

b =

c =

d =

Dear :

This letter responds to Taxpayer's letter dated October 24, 2002, requesting certain rulings under §§ 118(a) and 61 of the Internal Revenue Code.

The facts as represented by Taxpayer and Generator are as follows:

FACTS

Taxpayer, a State A corporation, is a regulated utility engaged in the business of transmitting and distributing electrical energy to wholesale and retail customers in State A. Taxpayer is a wholly owned subsidiary of Company A and joins with Company A and various affiliates in filing a consolidated Federal income tax return at Service Center. Taxpayer is under the audit jurisdiction of Division.

Generator is a State B limited liability company. Generator is a disregarded entity for Federal income tax purposes, and is wholly owned by another disregarded entity, Company B. Company B is wholly owned by Company C. Company C files a consolidated return as a member of a consolidated group of which Company D is the parent.

Taxpayer is required pursuant to Federal Energy Regulatory Commission (FERC) orders to accommodate any request from an independent power producer to interconnect a generating facility to Taxpayer's transmission system. However, any costs incurred to complete the interconnection or perform system upgrades must be paid or deposited by the interconnecting independent power producer. FERC policy requires Taxpayer to refund amounts deposited for system upgrades in the form of transmission credits.

Generator is an independent power producer that has proposed to construct, own, and operate Facility on property adjacent to Taxpayer's electricity transmission system. Facility will be comprised of a combined cycle plant consisting of two combustion turbines and one steam turbine, and have an estimated aggregate net generating capacity of approximately 640 megawatts. Facility is presently scheduled to enter commercial operations on or about Date 2 and is expected to have a useful life of approximately years. Prior to Facility's operation, Generator will seek a determination from FERC that Facility will be an Exempt Wholesale Generator within the meaning of § 32 of the Public Utility Holding Company Act of 1935, and will not be a Qualifying Facility under § 3 of the Federal Power Act, as amended by the Public Utility Regulatory Policies Act of 1978 (PURPA).

In order to sell the power produced at Facility, Generator requested interconnection to Taxpayer's transmission system. Taxpayer and Generator executed an Amended and Restated Interconnection Agreement ("the IA"), which was accepted by FERC on Date 1, and which sets forth the parties' agreements about how Generator will interconnect Facility with Taxpayer's grid, and following interconnection, parallel operation of Facility with Taxpayer's transmission system. (The IA is hereby incorporated and made part of this ruling). The IA shall continue in force and effect for a period of a years, or until retirement of the facility, whichever is shorter.

The IA requires Generator to bear the cost of construction of certain company interconnection facilities, which will be constructed and owned by Taxpayer. The estimated cost of construction of the company interconnection facilities is $b. In addition, Generator, at its expense is required to construct a 138 kV switching station ("the station"). Upon completion, Generator will transfer title to the station to Taxpayer. The estimated cost of the station is $c. The company interconnection facilities and the station together comprise the interconnection facilities.

In addition to the interconnection facilities, Taxpayer will make certain upgrades to Taxpayer's transmission system reasonably necessary to remedy short circuit and stability problems caused by Generator's interconnection and to accommodate the load from Facility. Generator is required to deposit the cost of these System Upgrades,[1] estimated at $d, with Taxpayer.

The IA and FERC policy require Taxpayer to refund the costs of the System Upgrades to Generator either in the form of transmission credits or cash. In accordance with FERC policy, § 3.7(g) of the IA, under the Open Access Transmission

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[1] The IA defines System Upgrades as "the minimum necessary local and network upgrades that would not have been required but for the Interconnection of the Facility to the Company Transmission System, including (i) system upgrades necessary to remove overloads and (ii) system upgrades necessary to remedy short-circuit or stability problems resulting from the connection of the Facility to the network, as such facilities are so designed and described in Appendix A." IA at § 1.41.

Tariff,[2] provides that as Taxpayer receives transmission service revenue from power produced at Facility, Generator or its assignee shall receive a credit, on a dollar-for-dollar basis, against the cost of transmission service. As indicated by Taxpayer, pursuant to FERC policy, Taxpayer must pay interest on transmission credits or cash refunds.[3] Under the IA, if the amounts paid for the System Upgrades are not refunded within months of the date Facility commences commercial operations, Taxpayer must refund to Generator, in cash, any remaining costs within 30 days. Assuming that Taxpayer is required to pay interest under 18 C.F.R. § 35.19a(a)(2) on the payments from Generator, the amount of interest payable is based on the average prime rate for each calendar quarter, compounded quarterly.

Title to the net output of power produced at Facility will be transferred to Generator's power customers before it enters Taxpayer's transmission system and Generator will not take transmission service from Taxpayer. Generator's customer(s) will be responsible for purchasing transmission service from Taxpayer under Taxpayer's OATT.

Because Generator will not take any transmission service from Taxpayer, Generator will either (i) assign, for consideration, all or a portion of the transmission credit to its power customer(s), whereby such customer(s) will be entitled to use the credit to offset transmission service charges owed to Taxpayer; or (ii) receive a cash refund directly from Taxpayer. In any event, Taxpayer will be required to refund 100% of the costs of the System Upgrades either in the form of transmission credits to Generator's power customer(s) or to Generator in cash.

Based on Generator's projections, it is reasonably certain that during the first ten taxable years of the utility, beginning with the year the property transferred is placed in service, less than two percent of the projected total power flowing over the intertie will flow back to Facility. In addition, no component of the interconnection facilities is needed solely for the transmission of power from Taxpayer to Generator.

Taxpayer makes the following additional representations: (1) none of the costs for the interconnection facilities will be included in Taxpayer's rate base; (2) in light of all the information available to it, Taxpayer is reasonably certain that during the first ten taxable years of the utility, beginning with the year the interconnection facilities are placed in service, no more than five percent of the projected total power flowing over the interconnection facilities will flow back to Facility and no part of the interconnection facilities is necessary solely for the transmission of electricity from Taxpayer or any third

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[2] The OATT is defined under the IA as "the Open Access Transmission Tariff under which [Taxpayer] offers non-discriminatory open access transmission service over the [Taxpayer] Transmission System, as filed with FERC, and as amended or supplemented from time to time, or any successor tariff." IA at § 1.32.

[3] Taxpayer was required by FERC to pay interest, pusuant to 18 CFR § 35.19a(a)(2)(iii) on transmission credits under its interconnection procedures with a different generator. See .

party to Generator; (3) Generator has represented to Taxpayer that title to the net output of power produced at Facility will pass to Generator's power customer(s) prior to entering Taxpayer's transmission system; (4) Taxpayer will not take any depreciation (or amortization) deductions with respect to the interconnection facilities. In addition, Generator represents that it will amortize the total cost of the interconnection facilities as an intangible asset, to be recovered using the straight-line method over a useful life of twenty years.

RULING REQUESTED

Taxpayer requests the Internal Revenue Service to rule that:

1) The transfer by Generator to Taxpayer of the interconnection facilities is not a contribution in aid of construction (CIAC) under § 118(b), and is excludable from Taxpayer's gross income as a nonshareholder contribution to capital under § 118(a);

2) The amounts deposited by Generator with Taxpayer for the construction of the System Upgrades constitute a loan or a refundable deposit not includable in Taxpayer's gross income under § 61.

LAW AND ANALYSIS

Issue (1)

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) provides that for purposes of subsection (a), except as provided in subsection (c), the term "contribution to the capital of the 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.

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, 2001-2 C.B. 619, provide 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.

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 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 (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.

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. 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 transfer of the interconnection facilities is subject to the guidance set forth in Notice 88-129, Notice 90-60, and Notice 2001-82 for the following reasons: (1) Facility is a stand-alone generator as contemplated under Notice 2001-82; (2) Generator and Taxpayer have entered into a long-term interconnection agreement with a term of a years or until retirement of Facility, whichever is shorter; (3) the

interconnection facilities will be used in connection with the transmission of electricity for sale to third parties (wheeling); (4) the cost of the interconnection facilities will not be included in Taxpayer's rate base; (5) Taxpayer will not claim a tax basis in the interconnection facilities; (6) based on all available information, during the ten taxable years beginning with the year in which the interconnection facilities are placed in service, Taxpayer is reasonably certain that no more than five percent of the total power that flows over the interconnection facilities will flow to Generator; (7) ownership of the electricity sold will pass from Generator to its customer(s) prior to its transmission on Taxpayer's transmission system; and (8) the cost of the interconnection facilities will be capitalized by Generator as an intangible asset and recovered using the straight-line method over a useful life of 20 years. Thus, we conclude that the deemed contribution of the interconnection facilities 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.

Next, we must decide whether the transfer qualifies 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 case 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), 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 591.

Finally, in United States v. Chicago, Burlington & Quincy R.R. Co., 412 U.S. 401 (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 R.R. 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 R.R. 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. Chicago, Burlington & Quincy Railroad Co., 412 U.S. at 413.

The proposed transfer of the interconnection facilities by Generator to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the interconnection facilities will become a permanent part of the Taxpayer's transmission system. Second, the transfer is not compensation for services provided for Generator by Taxpayer because Generator will not receive transmission services of any kind from Taxpayer. Third, the transfer is a bargained-for-exchange because Taxpayer and Generator entered into the necessary agreements willingly and at arm's length. Fourth, the transfer will foreseeably result in a benefit to Taxpayer commensurate with its value because the interconnection facilities will become a part of Taxpayer's transmission system. Fifth, the interconnection facilities will be used by Taxpayer in its trade or business for producing gross income. Therefore, Taxpayer's receipt from Generator of the interconnection facilities will be a contribution to capital under § 118(a).

Issue (2)

Finally, we must determine whether the amounts deposited by Generator with Taxpayer for the construction of the System Upgrades constitute a loan or a refundable deposit not includable in Taxpayer's gross income under § 61.

At issue is whether the loan from Generator to Taxpayer is a bona fide loan. Generally, for federal income tax purposes, a loan is defined as a legally enforceable obligation arising from a debtor-creditor relationship to pay a fixed or determinable sum of money.[4] No debt exists without a legal and enforceable obligation to repay.[5]

The existence of a debtor-creditor relationship is determined by examining the subjective intent of the parties and all relevant objective facts and circumstances pertinent to the advances. No one fact is determinative.[6] In determining the existence of bona fide debt, courts have examined whether 1) the promise was evidenced by a note or other evidence of indebtedness; 2) interest was charged; 3) a fixed schedule for repayments was set forth in the instrument or by agreement; 4) security or other collateral was given to insure repayment; 5) repayments were made; 6) the borrower was not insolvent at the time the advance was made; and 7) the parties otherwise acted in reliance that such transfer was a loan.[7]

In the instant case, no formal note is executed and no security or other collateral has been provided to insure repayment. However, interest is charged on Taxpayer's obligation.[8] Courts have sustained the Federal tax treatment of transactions as bona fide loans even in the absence of these formalities.[9] However, in the instant case, Taxpayer has a legal and enforceable obligation to repay Generator for the amounts advanced no later the end of the month after the commercial operation date of Facility.

Under existing case law, the contingency of repayment, standing alone, does not

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[4] *See*, for example, section 1.166-1(c) of the Income Tax Regulations.

[5] *See* A. Finkleberg's Sons, Inc. v. Commissioner, 17 T.C. 973 (1951).

[6] *See* Goldstein v. Commissioner, 40 T.C.M. 752, 755 (1980).

[7] *See* Goldstein, supra. *See also* Gilbert v. Comm'r, 262 F.2d 512, 513-4 (2nd Cir. 1958); Fin Hay Realty Co. v. U.S., 398 F.2d 694, 696 (3rd Cir. 1968).

[8] Taxpayer relies on "current FERC policy" in finding that interest should be paid to Generator for the use of Generator's advances. *See* requiring Taxpayer to pay interest, pursuant to 18 CFR §§ 35.19a(a)(2)(iii) on transmission credits under its interconnection procedures.

[9] *See, for example*, Miller v. Commissioner, 41 T.C.M. 139 (1980); Johnson v. Commissioner, 38 T.C.M. 17 (1979); and Ravano v. Commissioner, 26 T.C.M. 793 (1967).

always invalidate a loan for tax purposes.[10] Although payments on the loan are contingent, the loan's principal is contingent only with respect to timing, not amount.[11]

Treating the amount advanced by Generator to Taxpayer as a loan is consistent with case law dealing with the taxation of deposits. When there is an obligation to repay at the time a payment is advanced, the payment generally does not constitute taxable income to the recipient. The Court in Commissioner v. Indianapolis Power and Light Co., 493 U.S. 203, 110 S. Ct 589 (1990), stated that in determining whether a payment is taxable as income upon receipt or rather is a nontaxable item such as a deposit depends upon the parties' rights and obligations at the time the payments are made.[12] The Court noted that Indianapolis Power and Light Co.'s (IPL) deposits were acquired subject to an express obligation to repay, either at the time service was terminated or at the time a customer established good credit. The utility's unconstrained use of the deposits for an interim period was not crucial in deciding whether IPL had "complete dominion" over the deposits; the crucial factor was whether IPL had some guarantee that it would be allowed to keep the money. The court held that IPL's dominion over the deposits was insufficient to classify the deposits as income

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[10] *See* Saunders v. Commissioner, 720 F.2d 871, 873 (1983) (citing Dunn v. Commissioner, 615 F.2d 578 (2d Cir. 1980); and Island Petroleum Co. v. Commissioner, 57 F.2d 992 (4th Cir. 1932)).

[11] Although Notice 87-82, 1987-2 C.B. 389 (December 21, 1987) provides that, to the extent that repayment is contingent, the payment should be treated as a taxable CIAC rather than a loan, this language related to a purported loan to a utility from a person benefitting from utility services relating to the loan (e.g., a real estate developer, customer, or potential customer). In the instant facts, the lender (Generator) is not a person benefitting from Taxpayer's services.

[12] Similarly, in Illinois Power Company v. Commissioner, 72 F.2d 683 (7th Cir. 1986), the taxpayer, an electric company, collected revenue from rate increases to its commercial customers ordered by the Illinois Commerce Commission (ICC). The ICC stated that the purpose of its rate increase order was to discourage consumption by commercial customers, and informed the taxpayer at the outset of the rate increase that the taxpayer would not be allowed to keep the excess revenue generated by the increase. While the taxpayer was permitted to commingle the revenues with its general funds for an interim period, the ICC later ordered the taxpayer to refund the revenues, with interest, to its customers in the form of credits on their utility bills. Since the taxpayer knew from the start that it would have to pay back the revenues plus interest, the court held that the revenues were not income when received by the taxpayer. Rather, the court analogized the taxpayer's receipt of the funds as similar to that of a bank holding savings deposits or an employer that is required to withhold employees' social security taxes. *See* also Mutual Telephone Company v. U.S., 204 F.2d 160 (9th Cir. 1953).

at the time they were paid.

In the instant case, under the IA, Taxpayer has no guarantee that it would be allowed to keep the money. In contrast, Taxpayer has an unequivocal contractual obligation to repay the money advanced by Generator. Although Taxpayer derives a benefit from holding the funds advanced by Generator (the funds advanced finance the cost of the System Upgrades by Taxpayer), like the taxpayer in Indianapolis Power and Light Co., the lender has the power to force Taxpayer to refund the payments. In the instant case, Generator can force the utility to refund the payments no later the month after the commercial operation date of Facility.

Accordingly, based solely upon the above facts and the representations made by Taxpayer and Generator, we rule that:

1) The transfer of the interconnection facilities by Generator 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).

2) The payment by Generator to Taxpayer is a loan for Federal tax purposes under general tax principles.

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 Taxpayer's representation that less than five percent of the total projected power that flows over the interconnection facilities will flow from Taxpayer to Generator is a reasonable projection for purposes of the five-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,

/s/ Susan Reaman

Susan Reaman
Chief, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy

cc: