Internal Revenue Service

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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:5 — PLR-124341-03
Date:
August 8, 2003

LEGEND

Taxpayer =

Generator =

Current Owner =

Corp A =

Corp B =

Partnership =

Engineering Firm =

Customer A =

Customer B =

State A =

State B =

Address =

Agreement =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Dear :

This letter responds to your letter dated April 7, 2003 requesting a letter ruling concerning whether the transfer of an intertie from Generator to Taxpayer is a nonshareholder contribution to capital excludable from Taxpayer's income under § 118(a) of the Internal Revenue Code.

Taxpayer represents that the facts are as follows:

FACTS

Taxpayer is a regulated public utility incorporated in State A. Taxpayer's primary business is the transmission of electricity in markets subject to price regulation. Taxpayer is a wholly owned subsidiary of Corp A, a State B corporation. Taxpayer is a member of the consolidated group for federal income tax purposes of which Partnership is the common parent, a State B general partnership. Partnership has elected to be treated as a corporation for federal income tax purposes.

Current Owner, a State B limited liability company, operates a power generation facility (Facility) located at Address. The Facility was originally constructed by Generator, a State A corporation, and was placed into commercial operations in Date 1. Prior to the Date 1 in-service date, the Facility received certification as a Qualifying Facility from the Federal Energy Regulatory Commission in accordance with the Federal Power Act, as amended by the Public Utilities Regulatory Policy Act of 1978 (PURPA).

Taxpayer required Generator to pay for the design, engineering, and construction costs of a new 115 kv line and line tap and the associated equipment necessary to interconnect the Facility to Taxpayer's transmission grid (Intertie).

Taxpayer originally entered into an interconnection agreement on Date 2 (Interconnection Agreement) whereby Taxpayer and Generator agreed to interconnect the Facility to Taxpayer's transmission system in order to enable the transfer of electricity produced by the Facility from the Facility directly to the transmission grid, as well as to enable the Facility to receive any energy necessary to operate the Facility.

The Interconnection Agreement provided for an initial term of 20 years, beginning on the date that the interconnection facilities were ready for service.

The Facility was interconnected to Taxpayer's transmission grid by a dual-use intertie that allowed electricity to flow back in the direction of the Facility. At the time the Intertie was deemed transferred to Taxpayer, Generator reasonably projected that during the first ten taxable years of operation, beginning in the year the Intertie was deemed transferred, no more than 5 percent of the projected total power flows over the Intertie would flow in the direction of the Facility. An independent engineer's report dated Date 3 was prepared by Engineering Firm for Taxpayer and supported such projection.

The electricity produced by Generator at the Facility was primarily sold to utility companies in the wholesale power market (wheeling). In particular, according to the Interconnection Agreement and the Agreement dated Date 4, Generator originally sold the electricity produced by the Facility to both Customer A and Customer B. Generator also entered into a short-term power purchase agreement with Taxpayer.

In Date 5, Corp B assumed asset management of the Facility and in Date 6 expanded its responsibilities to include the operation and maintenance of the Facility. In Date 7, Current Owner, an affiliate of Corp B, acquired all of the Facility's assets from Generator and negotiated buy-outs of its existing power purchase agreements. Additionally, in the Agreement, Generator assigned, conveyed, transferred and delivered to Current Owner all of its obligations, rights, titles, and interests in the Interconnection Agreement. Thus, Current Owner assumed all of the liabilities and obligations of Generator under the Interconnection Agreement.

Taxpayer did not include the costs of the Intertie in the regulatory rate base upon which its rates are determined under standard cost-based rate regulation.

Ownership to the electricity produced by the Facility was transferred to the purchasers prior to its transmission on Taxpayer's transmission grid.

Generator (and Current Owner) capitalized the cost of the Intertie as an intangible asset, recovering such costs using the straight-line method of depreciation over a useful life of 20 years.

Taxpayer further represents that the characteristics described below are present with respect to the transfer of the Intertie by Generator to Taxpayer. First, the Intertie paid for by Generator became a permanent part of Taxpayer's transmission system as Taxpayer owns all of the facilities of the transmission system including all of the interconnection facilities. Second, the payment by Generator for the costs of design, engineering, and construction of the Intertie was not compensation for services provided by Taxpayer to Generator. Rather, the payment by Generator to Taxpayer was necessary to facilitate the sale of power by Generator to its customers. Third, the construction of the Intertie and the subsequent reimbursement for the costs of design, engineering, and construction was a bargained for exchange because Taxpayer and Generator negotiated and entered into the necessary agreements, including the Interconnection Agreement, willingly and at arms length. Fourth, the Intertie resulted in a benefit to Taxpayer commensurate with its value because the Intertie is part of Taxpayer's transmission system. Fifth, the Intertie is used by Taxpayer in its transmission business to produce income.

RULING REQUESTED

Taxpayer requests the Service to rule that the transfer of the Intertie by Generator to Taxpayer was not a contribution in aid of construction under § 118(b) (CIAC), and is 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, 2001-2 C.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 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. 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 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 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 recover such cost using the straight-line method over a useful life of 20 years.

In the instant case, the transfer of the Intertie is subject to the guidance set forth in Notice 88-129, Notice 90-60, and Notice 2001-82 for the following reasons: (1) the Facility was a Qualifying Facility under Notice 88-129 at the time of the transfer of the Intertie; (2) the transfer of the Intertie was made pursuant to a long-term interconnection agreement with an initial term of 20 years; (3) the Intertie is used in connection with the transmission of electricity for sale to third parties (wheeling); (4) the cost of the Intertie was not included in Taxpayer's rate base; (5) the Intertie is not a dual-use intertie; (6) ownership of the electricity produced by the Facility which is wheeled passes to the purchaser prior to its transmission on Taxpayer's transmission grid; and (7) the cost of the Intertie was capitalized by Generator (and Current Owner) 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 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 contribution 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 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 transfer of the Intertie by Generator to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the Intertie paid for by Generator became a permanent part of Taxpayer's transmission system as Taxpayer owns all of the facilities of the transmission system including all of the interconnection facilities. Second, the payment by Generator for the costs of design, engineering, and construction of the Intertie was not compensation for services provided by Taxpayer to Generator. Rather, the payment by Generator to Taxpayer was necessary to facilitate the sale of power by Generator to its customers. Third, the construction of the Intertie and the subsequent reimbursement for the costs of design, engineering, and construction was a bargained for exchange because Taxpayer and Generator negotiated and entered into the necessary agreements, including the Interconnection Agreement, willingly and at arms length. Fourth, the Intertie resulted in a benefit to Taxpayer commensurate with its value because the Intertie is part of Taxpayer's transmission system. Fifth, the Intertie is used by Taxpayer in its transmission business to produce income. Therefore, Taxpayer's receipt from Generator of the Intertie is a contribution to capital under § 118(a).

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer and Current Owner, we rule that the transfer of the Intertie by Generator to Taxpayer was not a CIAC under § 118(b) and is 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.

In accordance with the power of attorney filed with this request, we are sending copies of this letter ruling to your second authorized representative.

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
Senior Technician Reviewer
Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy