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Department of the Treasury

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CC:PSI:5 — PLR-130019-03
Date:
September 9, 2003

LEGEND

Corp 1 =

Corp 2 =

Corp 3 =

Corp 4 =

Corp 5 =

Corp 6 =

Corp 7 =

Substation 1 =

Substation 2 =

Substation 3 =

Substation 4 =

State A =

State B =

State D =

Location A =

Location B =

a =

b =

c =

d =

e =

f =

Dear :

This letter responds to your letter dated April 16, 2003, submitted on behalf of Corp 1, requesting a letter ruling concerning whether the payments made by Corp 6 to Corp 3, which, in turn, reimbursed Taxpayer for the cost of design, engineering and construction of the System Upgrades, will be excluded from Taxpayer's gross income as a contribution to the capital of Taxpayer under § 118(a) of the Internal Revenue Code, and will not be treated as a contribution in aid of construction to Taxpayer under § 118(b).

Corp 1 represents that the facts are as follows.

Corp 2 is a State A regulated public utility and Corp 3 is a State A and State B regulated public utility. The primary business of Corp 2 and Corp 3 is the supply and delivery of electricity and gas in markets subject to price regulation. Both Corp 2 and Corp 3 are wholly-owned subsidiaries of Corp 4, a State A Corporation. Corp 4 is a wholly-owned subsidiary of Corp 1. Corp 2 and Corp 3 are members of a consolidated group for federal income tax purposes, of which Corp 1 is the common parent. Collectively, Corp 1, Corp 2 and Corp 3 are referred to as Taxpayer.

Corp 6 is developing a d MW electric power generating facility located in Location A (the "Facility"). The Facility also is located within the service area of Corp 5 at Location B, which includes State A and parts of State B and State D. Pursuant to FERC Order No. 888, regulated public utilities must allow stand-alone power generators ("SAGs") to interconnect to the transmission grid so that the generators can sell or wheel power over the transmission grid for delivery to customers or other intermediaries (collectively, "Customers"). Corp 6 intends to interconnect the Facility with the transmission system owned by Corp 5 by interconnecting to Corp 5's newly constructed

Substation 1 (the “Interconnection”). Corp 6 expects that the Facility will commence commercial operations by a, and physically interconnect to Corp 5's transmission grid at that time.

Taxpayer also interconnects with Corp 5's transmission grid. Specifically, Corp 2 is connected to Corp 5's grid at the Corp 2-owned Substation 2, and Corp 3 is interconnected to Corp 5's grid at the Corp 3-owned Substation 3 and Substation 4. Absent certain modifications, the Facility’s interconnection with Corp 5's transmission grid will adversely impact Taxpayer’s transmission system. Modifications, upgrades and relocations of Taxpayer’s existing transmission network are necessary to accommodate the additional load that will be caused by output from the Facility. Taxpayer required Corp 6 to pay for the design, engineering and construction costs of all transmission line and substation modifications and network system upgrades (collectively, the “System Upgrades”) necessary to safely and reliably distribute the new source of generation. As described in more detail below, Taxpayer designed, engineered, constructed and retained ownership of the System Upgrades, and was reimbursed for all related costs and expenses by Corp 6. Consequently, Corp 6 entered into certain agreements that allowed the Facility access to Taxpayer’s transmission grid for the purpose of selling its power to customers.

Corp 7 and Corp 6 entered into an interconnection service agreement (the “ISA”) whereby Corp 6 requested and was granted interconnection service under the Corp 7 Open Access Transmission Tariff (“Corp 7 Tariff”). Corp 7 is the independent system operator that manages the reliability of the bulk power transmission system and facilitates the competitive wholesale power market in the service area in which the Facility operates. Essentially, Corp 7 coordinates the planning of all interconnected power generation to the transmission system located in the Corp 7 service area, manages the wholesale power market for the Corp 7 service area and provides accounting and billing services for all related transactions. In Taxpayer’s case, Corp 7 is the “middle-man” that approves the interconnection of the Facility to Corp 5's transmission grid and coordinates the construction of and payment for the System Upgrades.

The ISA provides for the design, construction and ongoing operations among Corp 6, Corp 7, Taxpayer and Corp 5. Taxpayer is responsible for the construction and ownership of the System Upgrades in accordance with the ISA. The ISA requires Corp 6 to reimburse Taxpayer for all costs relating to the System Upgrades and sets forth project milestones and technical requirements. The ISA also provides that all payments and billing activity must flow through Corp 7.

Pursuant to section b of the ISA, Corp 6 agreed to provide a letter of credit to Corp 7 in the amount of $c, naming Corp 7 as beneficiary, for the benefit of Corp 7, Corp 5 and Taxpayer, to secure the estimated costs of construction. The letter of credit is reduced semi-annually to reflect changes in the obligation. If Corp 7 increases or decreases Corp 6's share of the costs, Corp 6 or the grid owner would be responsible for remitting or refunding any difference. When construction is completed, there will be a final accounting and Corp 6 will pay the amount not already covered by its contributions, or alternatively, Taxpayer will refund any overpayment.

As provided in the Specifications for Interconnection Service Agreement, Corp 7 agreed that Corp 7 and Taxpayer would construct and upgrade and retain title to certain properties necessary to safely add reliably interconnect the Facility at a total estimated cost of $e. The system work and upgrades are described on page 6 of your ruling request.

The term of the ISA is the life of the Facility per the Corp 7 tariff. The agreement may be terminated at any time by mutual consent. Either party may terminate the agreement upon the permanent closure of the Facility or default. Pursuant to the Corp 7 tariff, either party may terminate upon the failure of Corp 6 to commence operations within f years of the effective date of the ISA. FERC approval is required for termination. Upon termination, Corp 6 is required to physically disconnect the Facility from the grid.

Title to the electricity produced by the Facility will pass to Customers prior to the transmission of the electricity on the transmission grid of Corp 5 and Taxpayer. Specifically, title to the electricity owned by Corp 6 will pass to Customers on the Facility side of the Interconnection.

The Interconnection between the Facility and Corp 5 as well as between Corp 5 and Taxpayer is a dual-use interconnection, which allows electricity to flow back in the direction of the Facility. This reverse power flow will occur during the start-up phase of the Facility, during emergencies or for maintenance. Corp 6 projects that during the first ten taxable years of operation, beginning in the year the System Upgrades are deemed transferred, no more than 5 percent of the projected total power flows over the System Upgrades will flow in the direction of the Facility.

Taxpayer will not include the costs of the System Upgrades in the regulatory rate base upon which its rates are determined under standard cost-based regulation. Rather, Corp 6 will pay for the costs of the System Upgrades by paying Corp 7, which, in turn, will reimburse Taxpayer. For income tax purposes, Corp 6 will capitalize the cost of the System Upgrades as an intangible asset, recovering such costs using the straight-line method of depreciation over a useful life of twenty years.

Taxpayer requests a ruling that the payments made by Corp 6 to Corp 7 that, in turn, reimbursed Taxpayer for the costs of design, engineering and construction of the System Upgrades (the "Indirect Reimbursement") will not be a contribution in aid of construction to Taxpayer under § 118(b) and will be excluded from Taxpayer's gross income as a contribution to capital under § 118(a).

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. 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 Indirect Reimbursement by Corp 6 to Taxpayer for the costs of design, engineering and construction of the System Upgrades 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 is a stand-alone generator as contemplated under Notice 2001-82; (2) Corp 6 and Taxpayer have entered into a long-term interconnection agreement; (3) the Interconnection will be used in connection with the transmission of electricity for sale to third parties; (4) the cost of the Interconnection will not be included in Taxpayer's rate base; (5) no more than 5 percent of the projected total power will flow back in the direction of the Facility during the first 10 taxable years of operation; (6) ownership of the electricity wheeled will not be with Corp 6 prior to its transmission on the grid; and (7) the cost of the Interconnection will be capitalized by Corp 6 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 Interconnection 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.

Based on the facts presented, we conclude that the Indirect Reimbursement by Corp 6 to Taxpayer for the costs of design, engineering and construction of the System Upgrades possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. Therefore, the Indirect Reimbursement by Corp 6 to Taxpayer will be a contribution to capital under § 118(a).

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer and Generator, we rule that the transfer of the Interconnection by Generator to Taxpayer will not constitute 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 Taxpayer's representation that less than five percent of the total projected power flows over the System Upgrades from Taxpayer to Corp 6 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.

In accordance with the power of attorney on file, copies of this letter are being sent to Taxpayer and the second authorized legal representative listed.

Sincerely,

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

Enclosure: 6110 copy