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Department of the Treasury
Washington, DC 20224

Person To Contact:
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Telephone Number:

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Date:
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LEGEND

Taxpayer =

Company A =

Contributor =

State A =

State B =

State C =

Region A =

Region B =

Agency =

Interconnection Facilities =

a =

b =

Dear :

This letter responds to a letter submitted on behalf of Taxpayer dated July 11, 2003 and subsequent correspondence, requesting a letter ruling concerning whether the transfer of interconnection facilities 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, a State A corporation, provides interstate natural gas transportation and natural gas storage services. Taxpayer owns approximately a miles of pipeline running from regions of State B, Region A, and south State C to Region B. Taxpayer also owns or leases storage capacity for approximately b cubic feet of natural gas. Taxpayer is within the regulatory jurisdiction of Agency pursuant to the Natural Gas Act of 1938 and the Natural Gas Policy Act of 1978.

Taxpayer is an indirect, wholly owned subsidiary of Company A, a State A corporation. Company A is the parent of a group of corporations that files a consolidated federal income tax return. Taxpayer is included as a member of this consolidated return.

Contributor, an owner of gas wells, is a State A corporation.

Contributor and Taxpayer are bound by a Facilities Agreement ("the FA"). The FA provides that Taxpayer will construct and own Interconnection Facilities. Contributor will reimburse Taxpayer for all costs associated with such construction. Under the FA, such payment will be made upon execution of the FA based on estimated costs. After completion, however, the FA requires a reconciliation whereby the amount of reimbursements will be made to equal the level of actual costs incurred by Taxpayer.

The FA imposes the following additional requirements. First, the term of the FA is ten years and thereafter until the final removal or abandonment of the Interconnection Facilities or of certain other related facilities, subject to two enumerated exceptions. Also, Taxpayer shall not include the Interconnection Facilities in its rate base and shall not reflect the reimbursements as revenues for purposes of the establishment of its rates.

In addition, Contributor makes the following representations: (1) that it will capitalize the cost of the Interconnection Facilities as an intangible asset and will recover such cost using the straight-line method over a useful life of 20 years; (2) that it is projected that not more than five percent of the total volume of gas flowing through the Interconnection Facilities will flow to Contributor during the first ten years of operation; and (3) that title to any gas sold by Contributor will pass to the purchaser prior to its transmission on Taxpayer's transmission system.

Taxpayer makes the following additional representations. The contribution of Interconnection Facilities received from Contributor will (1) become a permanent part of its working capital structure; (2) will not be a payment for services; (3) has been bargained for; (4) will produce a foreseeable benefit to Taxpayer commensurate with the contribution's value; and (5) will contribute to the production of additional income.

RULING REQUESTED

Taxpayer requests the Service to rule that the transfer by Contributor 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).

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 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.

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, 83d 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 CIAC 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) (Conference Report). 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 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 recover using the straight-line method over a useful life of 20 years.

In the instant case, the transfer of the Interconnection Facilities is analogous to a transfer to a regulated public utility and therefore is subject to the guidance set forth in Notice 88-129, Notice 90-60, and Notice 2001-82 for the following reasons: (1) Contributor is analogous to a stand-alone generator as contemplated under Notice 2001-82; (2) Contributor and Taxpayer are bound by a long-term facilities agreement governing their interconnection; (3) the Interconnection Facilities will be used in connection with the transmission of gas for sale to Contributor's customers; (4) the cost of the Interconnection Facilities will not be included in Taxpayer's rate base; (5) based on all available information, during the ten taxable years beginning with the year in which Facility is placed in service, no more than five percent of the total gas flows over the Interconnection Facilities will flow to Contributor; (6) ownership of the gas sold passes to the purchaser prior to its transmission on Taxpayer's transmission system; and (7) the cost of the Interconnection Facilities will be capitalized by Contributor 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 Contributor 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 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 Railroad 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 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. Chicago, Burlington & Quincy Railroad Co., 412 U.S. at 413.

Based on the facts represented, we conclude that the transfer of Interconnection Facilities by Contributor to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. Therefore, the transfer of the Interconnection Facilities by Contributor 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 Contributor, we rule that the transfer of the Interconnection Facilities by Contributor 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 Taxpayer's representation that less than five percent of the total projected gas flows over the Interconnection Facilities from Taxpayer to Contributor 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, a copy of this letter is being sent to Taxpayer's authorized representative.

Sincerely,

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

Enclosure: 6110 copy

cc