Internal Revenue Service

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EIN:

Taxpayer =
Corporation A =
Corporation B =
State =
City =
County =
Amount A =
Amount B =
Amount C =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

Dear :

This letter responds to a letter submitted on behalf of Taxpayer dated May 27, 2004, requesting a letter ruling concerning whether Taxpayer has to include certain surcharges (Underground Surcharges) it collects from its customers for City for undergrounding costs, in income under § 61 of the Internal Revenue Code (the Code), or, if such amounts are includable, whether Taxpayer is entitled to an offsetting deduction under § 162 of the Internal Revenue Code based on its payment of such amounts to City. In addition, Taxpayer is requesting a ruling concerning whether certain relocation payments (Relocation Payments) are includable in income or excluded as nonshareholder contributions to capital under § 118(a) of the Code. Taxpayer represents that the facts are as follows:

FACTS

Corporation A is the common parent of an affiliated group of corporations, including Taxpayer. Taxpayer is a State corporation and a principal subsidiary of Corporation B, a wholly-owned subsidiary of Corporation A. Taxpayer is an operating public utility that provides electric and gas service within State. Its business involves generation, purchase, transmission, distribution, and sale of electricity and natural gas. Taxpayer generates and purchases electricity and distributes it to Amount A customers in an area including County. It also purchases and distributes natural gas to Amount B customers in County and transports electricity and gas for others.

The City municipal code gives the city council the power to designate any area of the city as an underground utility district for aesthetic, health, or safety reasons. After such a designation, the electric utility, telephone, and cable television companies operating in the area must remove poles and bury their wires and other facilities, and they are barred from installing any new overhead equipment.

On Date 1, the city council adopted a resolution designating areas in City as underground utility districts and authorized an expenditure by the city "for the purpose of underground conversion of poles, overhead wires and associate[d] structures, administering the districts, minor city force work, street restoration, tree replacement, replacement of street lights, archeological monitoring, and other related work . . . ."

The city sent notices to property owners in the affected areas informing them that the utilities would be burying wires and that property owners would have to pay the cost of digging trenches from the curb to their homes unless the affected property owner returned a permit to enter form, in which case, Taxpayer would perform all the work at no cost.

In Date 2, Taxpayer asked the State public utilities commission, among other things, for an increase in the electricity surcharge paid by customers. Amount C of the increased surcharge would be paid to the city and deposited into a separate account to be used exclusively for expenses directly related to electric undergrounding. The Commission approved the increase in Date 3.

Taxpayer collects the Underground Surcharge by invoicing it through its regular bills. The Amount C surcharge was imposed beginning in Date 4. The money is paid directly to the city on a quarterly basis. The city then deposits it in a segregated account. The city directs how the money is invested and any interest earned is for its own account.

Taxpayer has a work plan that it negotiated with the city underground utility coordinator for burying power lines in the various underground utility districts. It does some of the work itself and hires contractors for other work. At the end of each month, the utility sends the city a bill for its expenses incurred that month, and the city sends a reimbursement check ("Relocation Payment"). If there is a shortfall in the account to cover the cost of work done, then the city is still legally obligated to reimburse the utility. The city keeps excess funds remaining in the account, if any, after the undergrounding project is complete.

The undergrounding project began in Date 5. Taxpayer will receive its first reimbursement check in Date 6.

LAW AND ANALYSIS

RULING REQUEST # 1: Gross Income

Section 61(a) of the Internal Revenue Code (the Code) provides that, except as otherwise provided by law, gross income means all income from whatever source derived. Under § 61 of the Code, Congress intends to tax all gains or undeniable accessions to wealth, clearly realized, over which taxpayers have complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207.

In Illinois Power Company v. Commissioner, 792 F.2d 683 (7th Cir. 1986), the taxpayer, an electric company, collected revenue from rate increases to its commercial customers, as 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 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).

In the instant case, Taxpayer is under a contractual obligation to collect the Underground Surcharges on behalf of City. Taxpayer in essence, acts merely as a custodian of the money collected and receives no beneficial interest in the revenue. Therefore, the revenue Taxpayer receives from the collection of the Underground Surcharge is not includible in income under § 61 or the Code.

RULING REQUEST # 2: Nonshareholder Contribution to Capital

Section 61(a) of the Code 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) of the Code provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Section 118(b) of the Code, 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 contribution in aid of construction (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 of the Code 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 of the Code 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).

In general, the amendment made by § 824 of the 1986 Act to § 118 of the Code was intended to require a regulated public utility to include in income the value of any CIAC made to encourage the provision of services by the utility to a customer. As a result under the 1986 Act, all CIACs, even those received by a regulated public utility such as Taxpayer, are includable in the gross income of the receiving corporation. The House Ways and Means Committee Report ("House Report") states that property, including money, is a CIAC, rather than a contribution to capital, if it is contributed to provide or encourage the provision of services to or for the benefit of the person making the contribution. H.R. Rep. No. 426, 99th Cong., 1st Sess. 644 (1985), 1986-3 (Vol. 2) C.B. 644.

A utility is considered as having received property to encourage the provision of services if any one of the following conditions is met: (1) the receipt of the property is a prerequisite to the provision of the services; (2) the receipt of the property results in the provision of services earlier than would have been the case had the property not been

received; or (3) the receipt of the property otherwise causes the transferor to be favored in any way. The House Report also states that the repeal of the special exclusion does not affect transfers of property that are not made for the provision of services, including situations where it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfers. H.R. Rep. No. 426, 99th Cong., 1st Sess. 644-45 (1985), 1986-3 (Vol. 2) C.B. 644-45.

Notice 87-82, 1987-2 C.B. 389, provides additional guidance on the treatment of CIACs. Notice 87-82 follows the language from the House Report and states that a payment received by a utility that does not reasonably relate to the provision of services by the utility or for the benefit of the person making the payment, but rather relates to the benefit of the public at large, is not a CIAC. In Notice 87-82, an example of a payment benefiting the public at large is a relocation payment received by a utility under a government program to place utility lines underground. In that situation, the relocation is undertaken for either reasons of community aesthetics or in the interest of public safety and does not directly benefit particular customers of the utility.

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.

In this case, the undergrounding of Taxpayer's power lines is mandated pursuant to the City Resolution, which was adopted on Date 1, that "the public health, safety, or general welfare require[s] the removal of poles, overhead wires and associated structures and the underground installation of wires and facilities..." within the districts designated by the Resolution. Accordingly, we conclude that the Relocation Payments to Taxpayer from the City for the undergrounding of the overhead lines will not be treated as a CIAC under § 118(b) of the Code. Furthermore, the payments to Taxpayer from the City meet the five characteristics of nonshareholder contributions to capital stated in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973).

CONCLUSION

Based solely on the foregoing analysis and the representations made by Taxpayer, we rule as follows:

- The revenue Taxpayer receives from the collection of the Underground Surcharge is not includible in income under §61 of the Code,

- The Relocation Payments received by Taxpayer from the City for undergrounding the existing overhead lines are nonshareholder contributions to the capital of Taxpayer under § 118(a) of the Code and are not CIACs under § 118(b).

- The basis in the Taxpayer's property is reduced under the rules provided by § 362(c)(2) and the regulations thereunder.

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.

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

Sincerely,

John M. Aramburu
Senior Counsel, Branch 5
(Income Tax & Accounting)

cc: