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Person To Contact:
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Telephone Number:

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Date:
February 15, 2008

In Re:

LEGEND:

Corp A =

Parent =

City =

Dear :

This letter responds to a letter, dated November 19, 2007, submitted by Corp A, requesting rulings under § 118 of the Internal Revenue Code.

FACTS

Corp A is a wholly owned subsidiary of Parent and a member of Parent's affiliated group that files a consolidated return. Corp A is in the business of purchasing, transmitting, distributing, and selling electric energy.

City has adopted a plan to underground the overhead utility lines and related equipment in the historic district of City. The purpose of the plan is the preservation of ocean views, the overall enhancement of the seashore community's appearance, and public safety by the removal of poles and overhead wires. City will pay Corp A for the undergrounding of the overhead electrical lines and related equipment. The undergrounding by Corp A will provide electric service to existing customers of Corp A.

LAW AND ANAYSIS

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 § 118(a) purposes, 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.

The House Ways and Means Committee Report for the Tax Reform Act of 1986 explains that property, including money, is a CIAC (rather than a capital contribution) if it is transferred to provide or encourage the provision of services to or for the benefit of the person transferring the property. H.R. Rep. No. 426, 99th Cong., 1st Sess. 644 (1985), 1986-3 (Vol. 2) C.B. 644. A utility has received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of the services; if 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 if the receipt of the property otherwise causes the transferor to be favored in any way. However, a transfer of property is not a CIAC where it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfer.

Notice 87-82, 1987-2 C.B. 389, provides that a payment received by a utility is not a CIAC if it 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. Notice 87-82 provides as an example of a payment benefiting the public at large a relocation payment received by a utility under a government program to place utility lines underground. In that situation, the relocation payment is not considered a CIAC where the relocation is undertaken for purposes of community aesthetics and public safety and does not directly benefit particular customers of the utility in their capacity as customers.

The payments made by City to Corp A to underground the overhead electrical lines and related equipment will benefit the public at large primarily by improving community aesthetics and public safety. Therefore, we conclude that the payments made by City to Corp A to underground the overhead electrical lines and related equipment fall within the public benefit exception described in the House Report and in Notice 87-82 and are not a CIAC under § 118(b).

Next, we must decide whether the payments qualify 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, 83rd 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 that were used by the company to construct the facilities necessary to deliver electricity to the customers were not nonshareholder contributions to capital. The Court found that the motivation for the prospective customers' contributions was to obtain electric services from the power company and, therefore, the contributions were payment for services. 319 U.S. at 102.

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, 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. Chicago, Burlington & Quincy Railroad Co., 412 U.S. at 413.

The payments made by City to Corp A to underground the overhead electrical lines and related equipment contain the characteristics of a nonshareholder contribution to capital described in Chicago, Burlington & Quincy Railroad Co. First, the undergrounded electrical lines and related equipment will become a permanent part of Corp A's working capital. Second, the payments are not compensation for services because, after the payments are made, Corp A will not be required to provide any services it is not providing at the present time. The undergrounding is not necessary other than as part of City's undergrounding program to improve community aesthetics and public safety. Third, the payments are a bargained-for exchange, because Corp A and City bargained at arms-length on the location and cost of the undergrounding of the lines and related equipment. Fourth, the payments foreseeably will result in a benefit to Corp A commensurate with their value because they will be used as part of Corp A's electrical distribution system over which it provides electricity for sale to its customers. Fifth, the undergrounded electrical lines and related equipment will be used by Corp A in its trade or business to produce income.

Therefore, we conclude that the payments made by City to Corp A to underground the overhead electrical lines and related equipment are a contribution to the capital of Corp A under § 118(a).

CONCLUSION

Accordingly, based on the foregoing analysis and the representations made, we conclude that the payments made by City to Corp A to underground the overhead electrical lines and related equipment are not a CIAC under § 118(b) and are a contribution to the capital of Corp A 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.

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

A copy of this letter should be filed with Parent's federal income tax return for the taxable year in which the contribution is made. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

PAUL F. HANDLEMAN
Acting Chief, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):
Copy of this letter
Copy for § 6110