Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel (Cincinnati, Group 2)
(Large & Mid-Size Business)

from: Senior Technician Reviewer, Branch 5
(Passthroughs & Special Industries)

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subject: Treatment of Transfer as Nonshareholder Capital Contribution under §118

This Chief Counsel Advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Parent Corporation =

City =

State =

Project 1 =

Project 2 =

X =

Y =

This chief counsel advice responds to your request for advice regarding §§ 118 and 61 of the Internal Revenue Code.

ISSUE

Whether the payments that Taxpayer received from X and Y as reimbursement to relocate Taxpayer's facilities to accommodate the development of Project 1 and Project 2 are nonshareholder contributions to capital under § 118(a) excluded from Taxpayer's gross income under § 61.

CONCLUSION

The payments that Taxpayer received from X and Y as reimbursement to relocate Taxpayer's facilities to accommodate the development of Project 1 and Project 2 are not nonshareholder contributions to capital under § 118(a) and are included in Taxpayer's gross income under § 61.

FACTS

Taxpayer, a wholly owned subsidiary of Parent Corporation, is a regulated public utility serving customers in and around City. Taxpayer owned land in City's downtown business district (the "Land") where Taxpayer operated utility substations that distributed utility service to customers within City's downtown business district. Taxpayer also owned and operated power transmission facilities consisting of towers and associated overhead and underground facilities that transmitted electricity from lines located on the periphery of City to the substations on the Land and provided electric distribution services to customers within the downtown business district.

City adopted a downtown development plan. Two of the development projects falling within the plan are Project 1 and Project 2 described below. City also adopted a land development code setting forth zoning and land use regulations that require the undergrounding of utilities for all new development in the downtown business district. Further, City enacted an ordinance establishing guidelines that require that utility services be installed underground when possible and that above ground utility components be screened by landscaping, decorative wall, or located away from public view.

Project 1

The governor of State formed a task force to provide recommendations for the construction and operation of Project 1 in City. The task force recommended that X be established to own and operate Project 1. In addition, the task force recommended that Project 1 be located in the downtown business district on a site that included the Land (the "Project 1 Site") because the Project 1 Site offered maximum economic and other benefits to City and State.

Taxpayer and X entered into a memorandum of understanding regarding the sale and purchase of the Land. Taxpayer agreed to sell the Land to X if X paid Taxpayer the fair market value of the Land and Taxpayer's actual out-of-pocket costs to relocate Taxpayer's facilities located on the Land (the "Project 1 Site Facilities"). Taxpayer did not need to sell the Land or relocate the Project 1 Site Facilities. Taxpayer and X entered into a land sale agreement and a relocation agreement. Under the terms of these agreements, Taxpayer agreed to sell the Land to X, and X agreed to pay Taxpayer the cost of relocating the Project 1 Site Facilities. The relocation costs include:

1. Reconstruction of the functionality of the existing transformers and associated switchgear as well as the air insulated switchyard with new, gas insulated equipment inside a new building, plus completion of the associated transmission and distribution circuit work required to support the transfer of functionality;
2. Use of existing substation locations to replace electric distribution circuits serving residential and small commercial customers from the existing facilities;
3. Relocation of two gas facilities that serve distribution customers in the immediate area;
4. Relocation of the information technology operations, information technology personnel facilities, and substation operations equipment and facilities;
5. Testing and switching of all new and relocated equipment and facilities; and
6. Engineering and design work associated with the activities above.

Taxpayer relocated the Project 1 Site Facilities to Taxpayer's land adjacent to the Land (the "Relocation Land") before any construction activities on Project 1 began.

The relocation of the Project 1 Site Facilities was subject to City's development code and guidelines and must meet the standards of those regulations.

The circuits that were relocated from the Land to the Relocation Land (the "Existing Circuits") will continue to serve the downtown business district. The Existing Circuits, however, will not serve Project 1. Taxpayer will install one or two new circuits on the Relocation Land for this purpose after Project 1's electrical facilities are constructed.

Project 2

City sold land in the downtown business district (the "Project 2 Site") to Y to develop Project 2 in City. The proposed plans for Project 2 required the relocation of Taxpayer's tower and existing underground transmission duct runs located on the Project 2 Site as well as Taxpayer's tower located near the Project 2 Site and the

associated overhead and underground electric transmission lines (collectively, the "Project 2 Site Facilities").

Taxpayer and Y entered into a relocation agreement in which Y agreed to pay a portion of the costs of relocating the Project 2 Site Facilities. Taxpayer did not have any need to remove or relocate the Project 2 Site Facilities. The relocation costs include:

1. Construction of a new terminal structure and associated transmission circuit work to replace the functionality of the existing towers;
2. Replacement of existing underground cables and duct run with XLPE (138 kV) and HPGF (69kV) cables in duct runs routed around existing buildings;
3. Testing and switching of all new and relocated equipment and facilities; and
4. Engineering and design work associated with the activities above.

Taxpayer agreed to bear a portion of the relocation costs because the relocation will involve the construction of new transmission facilities that will replace and modernize older transmission assets and, therefore, benefit Taxpayer and its customers.

The relocation of the Project 2 Site Facilities was subject to City's development code and guidelines and must meet the standards of those regulations.

The relocated Project 2 Site Facilities and/or new circuits will provide electric service to Project 2 after Project 2's electrical facilities have been constructed.

LAW AND ANALYSIS

As defined in § 61(a), gross income means all income from whatever source derived, unless otherwise excluded by law. Section 118(a), however, provides an exclusion from gross income for, in the case of a corporation, any contribution to the capital of the taxpayer. This section applies to capital contributions made by shareholders as well as to capital contributions made by persons other than shareholders. Treas. Reg. § 1.118-1. 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 inducing the corporation to locate its business in a particular community, or 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 for the purpose of inducing the taxpayer to limit production. See id.

Section 118(b), as amended by § 824(a) of the Tax Reform Act of 1986 (the Act), 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 Act explains that property, including money, is a CIAC (rather than a capital contribution) 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. 99-426, 99th Cong., 1st Sess. 644 (1985), 1986-3 (Vol. 2) C.B. 644 (the "House Report"). A utility has received property to encourage the provisions of services if: (1) the receipt of the property is a prerequisite to the provision of 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 property otherwise causes the transferor to be favored in any way. Id. at 644-645.

The Service published Notice 87-82, 1987-2 C.B. 389, to provide additional guidance on the tax treatment of fees paid to relocate utility facilities ("relocation fees"). Specifically, Notice 87-82 provides examples of relocation fees that are CIACs and those that are not. The central question of each example is the relationship of the payment to the provision of service. If the relocation fee does not reasonably relate to the provision of services by the utility to or for the benefit of the person making it but rather relates to the benefit of the public at large, the fee is not a CIAC under § 118(b).

For example, a relocation fee is not a CIAC where the relocation was undertaken under a government program for placing utility lines underground for community aesthetics and safety and not for the direct benefit of particular customers. Similarly, reimbursement for the costs of relocating utility facilities to accommodate the construction or expansion of a highway, and not for the provision of utility services, is not a CIAC.

A relocation fee is a CIAC, however, where a potential customer of the utility is required to pay for the utility's costs of relocating its facilities in order to obtain access to utility services for a site the customer is developing. It is immaterial whether the party requiring the relocation is a governmental entity. Moreover, payments relating to the relocation or extension of utility facilities to a newly constructed municipal building (e.g., civic center or museum) whose operations are conducted for the public benefit are CIACs where the payments were required to obtain utility services for the new building. As long as the payments are prerequisites to the provision of service to the customer, it is immaterial that the customer is exclusively engaging in activities for the public benefit.

The payments Taxpayer received from X and Y with respect to Project 1 and Project 2 fall within the latter examples. Through X, State and City sought to develop the Project 1 Site. They could not construct Project 1, however, on the desired location without first purchasing the Land from Taxpayer and relocating the Project 1 Site Facilities to another location. The payments X made to Taxpayer to relocate the Project 1 Site Facilities directly benefit X by removing the impediment to development. Further, X must pay the costs of relocating the Project 1 Site Facilities in order to obtain utility services at the Project 1 site once Project 1 is constructed.

Similarly, City and Y sought to develop the Project 2 Site but were obstructed by the location of the Project 2 Site Facilities. Similar to the payments from X, the payments from Y directly benefit Y because Y could not develop the Project 2 Site as planned without the removal of the Project 2 Site Facilities. Further, Y could not have obtained utility services at Project 2 without the relocation of the Project 2 Site Facilities.

Even if the reimbursements were not CIACs, they do not have the characteristics of nonshareholder contributions to capital as articulated by the Supreme Court.

In Detroit Edison v. Commissioner, 319 U.S. 98 (1943), the Court held that payments made by prospective customers to an electric utility to cover the cost of extending the utility's facilities to the customers' homes were part of the price of service and not contributions to capital. The Court found that the customers did not intend to make contributions to the taxpayer's capital and regarded the payments as the price of services, stating, "it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to" the utility. Id. at 102.

In Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), the Court held that money and property contributions to a corporation by community groups to induce the corporation to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned:

> Since in this case there are neither customers nor payments for service, we may infer a different purpose in the transactions between petitioner and the community groups. The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large. Under these circumstances the transfers manifested a definite purpose to enlarge the working capital of the company.

Id. at 591.

In United States v. Chicago, Burlington & Quincy R.R., 412 U.S. 401 (1973), the Court considered whether a taxpayer was entitled to depreciate the cost of certain improvements including highway undercrossings and overcrossings, crossing signals, signs, and floodlights, that had been funded by the federal government. The Court held that the government subsidies were not contributions to the taxpayer's capital. In considering the precedent of Brown Shoe and Detroit Edison, the Court identified from these cases the salient characteristics of a nonshareholder contribution to capital under the Internal Revenue Codes of 1939 and 1954: (1) it must become a permanent part of the transferee's working capital structure; (2) it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the

transferee; (3) it must be bargained for; (4) the asset transferred must foreseeably result in benefit to the transferee in an amount commensurate with its value; and (5) 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. In reaching its conclusion that the improvements at issue did not qualify as contributions to capital, the Court reasoned:

> Although the assets were not payments for specific, quantifiable services performed by CB&Q for the Government as a customer, other characteristics of the transaction lead us to the conclusion that, despite this, the assets did not qualify as contributions to capital. The facilities were not in any real sense bargained for by CB&Q. Indeed, except for the orders by state commissions and the government subsidies, the facilities would not have been constructed at all. . . . The transaction in substance was unilateral: CB&Q would accept the facilities if the Government would require their construction and would pay for them. . . . The facilities were peripheral to its business and did not materially contribute to the production of further income by the railroad. They simply replaced existing facilities or provided new, better, and safer ones where none otherwise would have been deemed necessary.

Id. at 413-414 (citations and footnotes omitted).

Applying the principles of Chicago Burlington, other courts have concluded that payments similar to those received by Taxpayer in this case were not capital contributions. For example, in Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497 (1980), the Tax Court addressed, among others, the proper treatment of payments received by the taxpayer from various governmental bodies to acquire replacement railroad facilities. The court found that the governmental bodies had no intention to contribute to the taxpayer's capital and, indeed, had not considered the taxpayer's need for capital funds when it agreed to bear the costs of constructing the new facilities. Id. at 763. The court also found that the payments were not, in any real sense, bargained for.

> Here . . . the facilities were necessitated by Government action and would not have been constructed or acquired by petitioner in the absence of such action. The only element of meaningful bargaining shown by the record relates to the extent that petitioner would pay for any betterments. . . . There were no negotiations directed at inducing the governmental body to provide a replacement since there was never any question that a replacement would be forthcoming. Petitioner was, therefore, never called upon to bargain for a transfer of property or for the payment of construction costs. As in the CB&Q case, the present transfers of property (and the payment of costs) came about as the result of what is in substance unilateral action by the governmental entities.

Id. at 762 (footnotes omitted). The court further found that the acquired assets did not materially contribute to the production of any additional income.

> Any benefits inuring fortuitously to petitioner by virtue of the newness of a replacement line (e.g., the ability to increase train speed where curves had been reduced) were merely incidental, and do not appear on this record to have substantial financial impact. Petitioner's financial position was basically unchanged by the transactions.
>
> In each instance, there was "essentially an exchange of values or a payment for a specific quid pro quo" which did not contribute to the production of additional income or leave petitioner any better off.

Id. at 763-64 (citations and footnotes omitted).

Similar to the payments in Southern Pacific, the reimbursements that Taxpayer received from X and Y were not bargained for and did not contribute to the production of additional income. Similar to the petitioner in Southern Pacific, Taxpayer relocated the facilities in order to accommodate the government's goals, the construction of Project 1 and Project 2. Taxpayer would not have constructed or relocated its facilities but for the government's desire to develop the Project 1 Site and the Project 2 Site. Because the facilities served City, there was no question that the facilities would be relocated or replaced or that X and Y would pay for the relocation. Consequently, Taxpayer did not need to bargain for the relocation or induce X and Y to pay. Further, because the facilities were simply relocated, Taxpayer remained in the same economic position that it would have been in without the relocation. Any benefits that Taxpayer may receive as a consequence of any new construction are inconsequential. Similar to the payments in Chicago Burlington and Southern Pacific, the reimbursements here do not fall within the meaning of nonshareholder contributions to capital under § 118(a).

Accordingly, we conclude that the payments that Taxpayer received from X and Y as reimbursement to relocate Taxpayer's facilities to accommodate the development of Project 1 and Project 2 are not nonshareholder contributions to capital under § 118(a) and are included in Taxpayer's gross income under § 61.

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