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Department of the Treasury
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Person To Contact:
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Telephone Number:

Refer Reply To:
CC:PSI:B05
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Date:
March 02, 2011

Legend

Taxpayer =

Corp 1 =

Corp 2 =

Generator =

State 1 =

State 2 =

Facility =

Site =

Substation 1 =

Substation 2 =

Date 1 =

Agreement 1 =

Agreement 2 =

Agreement 3 =

c =

d =

e =

f =

g =

Dear :

This letter responds to your letter dated September 9, 2010, requesting a letter ruling concerning whether the transfer of an intertie from Generator to Taxpayer is a nonshareholder contribution to capital excludable from Taxpayer's income under § 118(a) of the Internal Revenue Code.

Taxpayer is a State 2 Corporation engaged in the business of generating, transmitting and distributing electrical energy to wholesale and retail customers predominantly in State 2. Taxpayer is a wholly-owned subsidiary of Corp 1, a State 2 corporation. Taxpayer and Corp 1 file a consolidated federal income tax return on a calendar year basis using the accrual method of accounting.

Generator, a State 1 limited liability company, will own, operate and maintain Facility located at Site. Generator submitted applications to Taxpayer for interconnection of Facility with the transmission and distribution system belonging to Taxpayer and Corp 2 (collectively the "Grid") at Substation 1.

On Date 1, Taxpayer filed Agreement 1, Agreement 2 and Agreement 3 (collectively, the "Agreements") between Taxpayer and Generator. Under the Agreements, Generator requests that Taxpayer interconnect Facility to Taxpayer's distribution system via a dedicated position at Substation 2. Taxpayer will engineer, design, procure, construct, install, own, operate, and maintain the facilities required to interconnect Facility to Taxpayer's distribution system (the "Interconnection Facilities"). Taxpayer also will engineer, design, procure construct, install, own, operate and maintain certain upgrades to its distribution system ("Distribution Upgrades"). Generator is responsible for the costs of those assets, which are estimated to be $c.

Agreement 3 specifies the terms and conditions under which Taxpayer will engineer, design, procure, construct, install, own, operate and maintain the

Facilities, and for Generator to pay for the Facilities. The Facilities are the facilities necessary to connect Facility's switchyard to the Interconnection Facilities at Substation 2 other than the Interconnection Facilities and the Distribution Upgrades. The cost of the Facilities is estimated to be $d.

The Interconnection Facilities, the Distribution Upgrades, and the Facilities, together are referred to as the "intertie."

Agreement 2 sets forth Taxpayer's agreement to provide distribution service for e Megawatts produced by Facility from Facility's interconnection at Substation 2 to the Grid at Substation 1. Agreement 2 terminates on the earliest of 1) f years from the commencement of distribution service under Agreement 2, or 2) the termination of Agreement 1. Agreement 1 has a term of f years and is automatically renewed for each successive g-year period.

Taxpayer will be the owner and sole operator of the intertie and the intertie will become a permanent part of Taxpayer's transmission and distribution system. Generator has entered into contracts and expects to enter into additional contracts with end users and power marketers to sell power from Facility. Taxpayer represents that the intertie will not be included in Taxpayer's rate base, and that Taxpayer will not take any depreciation deductions with respect to the intertie.

Generator represents: (1) Facility is a stand-alone generator as contemplated under Notice 2001-82; (2) The intertie will be used in connection with the transmission and distribution of electricity for sale to third parties; (3) Title to the electricity will pass to purchasers at the busbar on Facility's end of the intertie; (4) Generator will capitalize the contribution as an intangible asset and recovered using the straight-line method of accounting over a useful life of 20 years; and (5) Any portion of the intertie that is a dual use intertie within the meaning of Notice 88-129, 1988-2 C.B. 541, is reasonably expected to carry no more than a de minimis amount of electricity to Facility or to Generator or a related person (defined as no more than 5 percent of the projected power flows in both directions over the intertie during Generator's first 10 years after the intertie is placed in service).

Taxpayer requests a ruling that the contribution of cash for construction of the intertie by Generator to Taxpayer will not be considered a contribution in aid of construction under § 118(b) (CIAC), and will be excludable from Taxpayer's income as a non-shareholder 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, 2001-2 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 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 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 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 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 such cost using the straight-line method over a useful life of 20 years.

In the instant case, the transfer of the intertie is subject to the guidance set forth in Notice 88-129, Notice 90-60, and Notice 2001-82 for the following reasons: (1) Facility is a stand-alone generator as contemplated under Notice 2001-82; (2) Generator and Taxpayer entered into a long-term interconnection agreement; (3) the intertie will be used in connection with the transmission of electricity for sale to third parties (wheeling); (4) the cost of the intertie paid by Generator will not be included in Taxpayer's rate base; (5) Taxpayer will not take any depreciation deductions with respect to the intertie; (6) based on all available information, the portion of the intertie that is a dual use intertie is reasonably expected to carry no more than 5 percent of the projected power flows in both directions over the intertie during the first 10 taxable years beginning in the year the intertie is placed in service; (7) ownership of the electricity produced by Facility that is wheeled will pass to the purchaser prior to its transmission on Taxpayer's transmission grid; and (8) the cost of the intertie will be capitalized by

Generator 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 intertie 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 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), 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.

The transfer of the intertie by Generator to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the intertie will become a permanent part of Taxpayer's working capital structure. Second, the transfer is not compensation for services provided by for Generator by Taxpayer. Third, the transfer is a bargained-for exchange. Fourth, the transfer will foreseeably result in a benefit to Taxpayer commensurate with its value because the intertie will become part of Taxpayer's transmission system. Fifth, the intertie will be used by Taxpayer in its trade or business for producing gross income. Therefore, Taxpayer's receipt from Generator of the intertie will be a contribution to capital under § 118(a).

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer, we rule that the transfer of the intertie by Generator 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.

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.

This ruling is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Nicole R. Cimino

Nicole R. Cimino
Senior Technician Reviewer, Branch 5
(Passthroughs & Special Industries)

Enclosure (6110 copy)

cc: