Internal Revenue Service

Number: **201451007**
Release Date: 12/19/2014

Index Number: 118.01-04

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B05
PLR-109652-14

Date:
September 05, 2014

In Re:

Legend

Taxpayer	=
Corp 1	=
Corp 2	=
Corp 3	=
Corp 4	=
Administrator 1	=
Administrator 2	=
State 1	=
State 2	=
City 1	=
City 2	=
Agreement 1	=
Agreement 2	=
Agreement 3	=

Right 1	=	
Right 2	=	
System 2	=	
Year 1	=	
Year 2	=	
Date 1	=	
Date 2	=	
Date 3	=	
b	=	
c	=	
d	=	
e	=	
f	=	
g	=	
h	=	
i	=	
j	=	
k	=	
l	=	
m	=	
n	=	

Dear :

This letter responds to a request for a ruling dated March 7, 2014, and subsequent correspondence, submitted on behalf of Taxpayer by your authorized representatives. Taxpayer requested a ruling that certain payments Taxpayer receives from Corp 1 are contributions to the capital of Taxpayer under § 118(a) of the Internal Revenue Code. The relevant facts as represented in your submission are set forth below.

Taxpayer is an electric and gas utility primarily engaged in the transmission and distribution of electric energy and gas service in State 2. Taxpayer owns and maintains an electric transmission system in State 2 (Taxpayer's System) and is a transmission owning member of Administrator 1. Taxpayer is wholly owned by Corp 4. Both Taxpayer and Corp 4 are State 2 corporations. Taxpayer is included in a consolidated federal income tax return of which Corp 4 is the common parent.

Corp 1 is a corporate municipal instrumentality and political subdivision of State 1 that owns, maintains, and operates electric energy generation and transmission facilities in State 1. Corp 1's mission is to provide clean, low-cost and reliable energy for its customers and all residents of State 1. Corp 1 generates, transmits, purchases, and sells electricity to provide electric service to its numerous customers throughout State 1. In Year 2, approximately e of Corp 1's customer sales were to its City 1 customers.

In Year 1, Corp 1 authorized contract negotiations with Corp 2 to meet the growing electric needs of electricity consumers in the City 1 metropolitan area. As a result, Corp 1 entered into an agreement with Corp 2 for the development of a b megawatt transmission line connecting the electric transmission grids of State 2 and City 2 (the Project), which Corp 2 agreed to build, own, and operate. Corp 1 also agreed to pay for and received the rights to c percent of the transmission capacity of the Project (or d megawatts). The Project also establishes a connection between the regional transmission grids administered by Administrator 1 and Administrator 2. The State 2 connection interties to and is owned and operated by Taxpayer. The City 2 connection interties to and is owned and operated by Corp 3, a transmission-owning member of Administrator 2.

In order for the regional transmission grid to accommodate the expected increased electric energy flows on Taxpayer's System created by the Project, Administrator 1 required Taxpayer to complete a number of upgrades to Taxpayer's System (the Upgrades). Pursuant to an agreement among Administrator 1, Taxpayer, and Corp 2, Corp 2 is liable for reimbursing Taxpayer for the costs of the Upgrades.

Specifically, Taxpayer entered into Agreement 1 with Administrator 1 and Corp 2, under which Corp 2 agreed, among other things, to reimburse Administrator 1 for the cost of the Upgrades. Agreement 1 also enables Administrator 1 to award Corp 2 certain transmission rights (Right 1 and Right 2). Corp 2 assigned a portion of these rights to Corp 1.

As required by the Administrator 1 rules, Corp 2 entered into Agreement 2 with Administrator 1 and Taxpayer for Taxpayer to construct the Upgrades. Pursuant to Agreement 2, Taxpayer agreed to construct the Upgrades on Taxpayer's System at Corp 2's cost. Agreement 2 also requires Corp 2 to indemnify Taxpayer for any taxes associated with the Upgrades.

As of Date 1, only a portion of the Upgrades were completed, and Administrator 1 had only awarded k megawatts of Right 1. However, Corp 1 is able to schedule electric energy deliveries from Administrator 1 into City 1 over the Project up to the maximum electric transmission capability available, but may schedule only k megawatts on a firm basis. Once all Upgrades have been completed, Corp 1 will be able to schedule electric energy deliveries of up to f megawatts of electric energy on a firm basis at all times, and the remainder of its d megawatt entitlement on a non-firm basis.

In order to effectuate the development of the Project, Corp 1 and Corp 2 entered into a n-year Agreement 3 under which Corp 2 agreed to build, own, and operate the Project, and Corp 1 agreed to pay for, and received the rights to, c percent or d megawatts of the total transmission capacity of the Project. Corp 1 agreed to make monthly contract payments to Corp 2 for the transmission capacity share of the Project and to reimburse Corp 2 for the full cost of the Upgrades.

Although Corp 1 is ultimately responsible for the full cost of all Upgrades on Taxpayer's System, Corp 1 only has the rights to c percent of the Project's transmission capacity. Corp 1 is obligated to make the monthly payments regardless of whether or not it uses its full share of the transmission capacity. Since the Project's Date 3 commencement of operations, Corp 1 has only used an average of l megawatts per month.

Agreement 3 also provides that when Administrator 1 awards Right 1 for the Project, Corp 2 will assign the first f megawatts of Right 1 and c percent of Right 2 to Corp 1. Corp 2 retained m percent of the Project transmission capacity for its own use as a merchant transmission operator. Corp 1 has not yet received and does not anticipate receiving Right 2 in connection with the Project.

Although in Year 1, Corp 1 expected to earn revenues from economic electric sales using its portion of the transmission capacity of the Project, and Administrator 1 will award Right 2, Corp 1 does not anticipate earning sufficient revenue to recover its payments for the Upgrades or monthly capacity payments to Corp 2 under Agreement

3. In Year 1, Corp 1 estimated that the under-recovery of its costs would range between $g and $h. However, Corp 1 acknowledges that Agreement 3 includes provisions designed to provide more long-term value for, and help prevent losses to Corp 1.

Corp 1 acknowledges that the estimated under-recovery amount does not take into consideration yet-to-be negotiated customer agreements with Corp 1's customers. In Year 1, Corp 1 contemplated entering into customer agreements to collect fixed monthly payments from the City 1 customers to help defray but not eliminate Corp 1's under-recovery. However, those negotiations to date have not resulted in any recovery mechanism for the Project costs.

Agreement 3 requires Corp 1 to reimburse Corp 2 for the cost of the Upgrades and any associated tax costs. Corp 1 began that process on Date 2, shortly after the commercial operation of the Project, when it reimbursed Corp 2 $j for the cost of the Upgrades to Taxpayer's System and System 2 (excluding associated tax costs). Corp 2 and Corp 1 subsequently arranged for Corp 1 to remit such payments directly to Administrator 1 in the future. Also on Date 2, Corp 1 posted security with Administrator 1 for an additional $i of remaining Upgrade costs and posted security for the associated tax costs. Meanwhile Corp 1 has paid Administrator 1 for the costs of the continued Upgrade work. Corp 2 remains contractually liable to Taxpayer in the event Corp 1 were to fail to reimburse the cost of the Upgrades.

Taxpayer represents that the Project benefits the public at large in State 1 because the Project provides enhanced transmission reliability and security, significant economic benefits to electricity consumers, increased public safety, and increased access to cleaner generation. Also, the Project indirectly benefits the general public in State 1 through improvements to the essential public services provided by the City 1 customers. In addition, the Project enhances the performance of Corp 3's entire delivery system. Therefore, all electricity consumers in the metropolitan area of City 1, the vast majority which are not power customers of Corp 1, will receive direct benefits from the Project. Additionally, because Corp 1 is the sole electric supplier to its City 1 customers, numerous essential public services depend on Corp 1 for electricity. Taxpayer represents that City 1's customers will only receive benefits of the Project in their capacity as members of the public at large, and they will not receive any benefits of the Project beyond those received by all electricity consumers in State 1 who are not customers of Corp 1.

Taxpayer requests a ruling that the payments Taxpayer receives from Corp 1as reimbursement for the Upgrades are contributions to the capital of Taxpayer under § 118(a).

Section 61 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 the term “contribution to the capital of the taxpayer” does not include any contribution in aid of construction or any other contribution as a customer or potential customer.

Section 1.118-1 of the Income Tax Regulations provides that in the case of a corporation, § 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 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 inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities.

The legislative history of section 118 provides, in part, as follows:

> This [section 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 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 customer’s 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, 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.

Therefore, to determine whether or not Corp 1's payments for the Upgrades are contributions to capital under § 118, we must examine Corp 1's motivation for making the payments. While we recognize that the Upgrades will benefit the general public, we believe, based on the facts submitted, that Corp 1 was motivated to pay for the Upgrades for the direct benefit of its own customers.

Therefore, we rule that the payments Taxpayer receives from Corp 1 as reimbursement for the Upgrades are not contributions to the capital of Taxpayer 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 Cimino
Senior Technician Reviewer, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy