Internal Revenue Service **Department of the Treasury**

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Person to Contact:

Telephone Number:

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Refer Reply To:
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Date:
August 23, 2001

In re:

LEGEND

Taxpayer	=
State	=
Region	=
Corporation A	=
Corporation B	=
Division	=
Statute A	=
Statute B	=
Statute C	=
Act	=
Commission	=
Year 1	=
Year 2	=
Year 3	=
Date 1	=
Date 2	=
a	=
b	=

Dear :

This letter responds to your letter dated May 7, 2001, and subsequent correspondence submitted on behalf of Taxpayer, requesting a letter ruling concerning whether amounts contributed by State to Taxpayer in connection with the

development and construction of a natural gas transmission and distribution system are nonshareholder contributions to capital excludable from income under § 118(a) of the Internal Revenue Code.

Taxpayer represents that the facts are as follows.

FACTS

Taxpayer is a corporation organized under the laws of State for the purpose of owning and operating a natural gas transmission and distribution system. Taxpayer is owned jointly by Corporation A and Corporation B. Taxpayer is under the audit jurisdiction of Division.

Major sections of Region are unserved by natural gas. Lack of natural gas service has been a deterrent to attracting new businesses and investment to Region. The State legislature determined as a matter of public policy that State should find ways to encourage the development of natural gas service in regions within State that are unserved. The State legislature in Statute A declared it to be the policy of State "[t]o facilitate the construction of facilities in and the extension of natural gas service to unserved areas in order to promote the public welfare throughout the State...."

In furtherance of this policy, State enacted legislation setting forth certain procedures to ensure the orderly expansion of natural gas service (Statute B in Year 1). In Year 2, Statute C encouraged the creation of expansion funds to finance the expansion of natural gas service. In Year 3, State enacted the Act which authorizes the Commission to fund natural gas expansion projects by (1) appropriations of the State General Assembly or (2) the proceeds from the sale of state general obligation bonds. Funding under the Act is available to (a) existing natural gas local distribution companies, or (b) a person or gas district awarded a franchise for the construction of natural gas facilities. A natural gas expansion project may qualify for funding under the Act if it is economically infeasible. The Act defines the term economically infeasible as having a negative net present value. The net present value is generally the difference between (a) the cost of the project and (b) the anticipated net revenue to be generated by the project during its useful life, each discounted to their present value. If an expansion project later becomes economically feasible, the recipient of bond proceeds may be required to return the bond proceeds with interest.

Taxpayer filed an application with the Commission for an award of bond proceeds to pay for the "economically infeasible" portion of the cost of developing and constructing a natural gas transmission and distribution system in Region (Project). The bond application contains an analysis of the Project's net present value, as required by the Act and the Commission's regulations issued thereunder. Based on this analysis, the Project has a net negative present value. Specifically, the present value of the total anticipated cost of the Project exceeds the present value of the anticipated net revenue

generated over the useful life of the Project. Thus, the Project's anticipated negative net present value qualifies the Project for funding under the Act.

The Commission awarded the bond proceeds to Taxpayer by its orders of Date 1 and Date 2. Pursuant to these orders, bond proceeds in the total amount of $a were made available for the development and construction of the Project. The total amount of bond proceeds represents the cost of the Project that is economically infeasible based on the present value of revenues that the Project is anticipated to generate. Based on this rationale, the Commission determined that the Project is economically infeasible because it has a negative net present value in excess of $b.

The bond proceeds are subject to refund if (1) the Commission investigates the economic feasibility of the Project and (2) the Project is determined to be economically feasible based on the present value methodology. While the Act and Commission rules set forth the requirement for refunding of bond proceeds, it is extremely unlikely that a refunding could occur. In order for the Project to become economically feasible, the present value of the actual net revenues generated by the Project must exceed the anticipated revenues to the point of eliminating the existing negative net present value of $b. Taxpayer is not aware of any circumstances by which the net revenues generated by the Project could achieve this result. The potential refunding of bond proceeds is an extremely remote contingency.

Moreover, the proposed rate structure for the Project is not designed to achieve economic feasibility. The rates that Taxpayer will charge for natural gas service are designed to pay for (1) the operation and maintenance costs of the Project, and (2) the annual rate of return on the Contribution. Thus, under the rate structure proposed by Taxpayer, the Project will not achieve economic feasibility.

Taxpayer also represents that: (1) the bond proceeds will fund the Project which will be owned and operated by Taxpayer, and therefore, will become a permanent part of Taxpayer's working capital structure; (2) the contribution of the bond proceeds by State to Taxpayer is not compensation for services; (3) the contribution is a bargained for exchange; (4) because the contribution will be used to fund the construction and development of the Project, the contribution will result in a benefit to Taxpayer in an amount commensurate with its value; (5) the Project will permit Taxpayer to provide natural gas service to Region, and Taxpayer will be entitled to charge regulated rates

for the provision of natural gas services; therefore, the contribution will contribute to the production of income by Taxpayer and the value of the contribution will be assured in that respect.

RULING REQUESTED

Taxpayer requests the Service to rule that the amounts contributed by State to Taxpayer for the development of the Project will not be a contribution in aid of construction (CIAC) under §118(b) and will constitute nonshareholder contributions to capital under § 118(a).

LAW AND ANALYSIS

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), provides that for purposes of exclusion under § 118(a), except as provided in § 118(c), a contribution to the capital of the 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 applies to contributions to capital made by persons other than shareholders. 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, 83rd Cong., 2d Sess. 18-19 (1954).

In general, the amendment made by § 824 of the 1986 Act to § 118 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, 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 are 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 be 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 general 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 to 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 benefitting 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.

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, 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), 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, B. & Q. R. 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, B. & Q. R. 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, B. & Q. R. 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.

In the present case, Taxpayer was awarded bond proceeds in the total amount of $a for the development and construction of the Project pursuant to the Commission's authority under the Act to fund natural gas expansion projects. The Act was enacted in furtherance of the expressly stated policy of State under Statute A to facilitate the expansion of natural gas service to unserved areas in order to promote the public welfare throughout State. It is clear that the funding of the Project under the Act advances this public policy. Accordingly, we conclude that the contribution of the bond proceeds by State to Taxpayer for the development and construction of the economically infeasible portion of the Project falls within the public benefit exception described in Brown Shoe Co. and will not be treated as a CIAC under § 118(b). Furthermore, the contribution of the bond proceeds to Taxpayer meets the five characteristics of a nonshareholder contribution to capital stated in Chicago, B. & Q. R. Co.

Based solely on the foregoing analysis and the representations made by Taxpayer, we rule that the contribution of the bond proceeds by State to Taxpayer is not a CIAC under § 118(b) and constitutes a nonshareholder contribution to capital under § 118(a).

In accordance with the power of attorney, we are sending a copy of this letter to Taxpayer and to Taxpayer's second authorized representative.

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

Sincerely,

Walter H. Woo
Senior Technician Reviewer, Branch 5
Office of Associate Chief Counsel, Passthroughs and Special Industries

cc: