Internal Revenue Service

Department of the Treasury

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LEGEND

Taxpayer =
State A =
Corporation B =
City C =
Substation D =
City E =
Company F =
Urban Renewal Area G =
a =
b =

Dear :

This letter responds to your letter of November 8, 2001, and subsequent correspondence submitted on behalf of Taxpayer, requesting a private letter ruling that amounts paid by a local development authority in connection with the design, construction and installation of a substation upgrade represents a contribution to the capital of Taxpayer under section 118(a) of the Internal Revenue Code and not contributions in aid of construction under section 118(b). Taxpayer provides the following representations.

FACTS

Taxpayer is an investor-owned, regulated public utility company organized and existing under the laws of State A. Taxpayer is engaged principally in the business of electrical generation, transmission, and distribution. Taxpayer files a consolidated return with its parent Corporation B; both are accrual, calendar year taxpayers that file a consolidated return with the District Director of the Internal Revenue Service in City C.

Taxpayer intends to install two new high voltage circuit breakers at Substation D in City E. The total cost of the upgrade is expected to be a. The new circuit breakers will have a high-speed communication network with other circuit breakers on either side of the power “loop” in the area. When a problem occurs on the “loop”, the new circuit breakers will isolate the faulty section quickly. This upgrade is expected to reduce outage times from the current 2-30 seconds to 0.0667 seconds. The upgrade will

primarily benefit industrial customers in a designated revenue allocation district.

Taxpayer represents that the City E development authority, a state entity charged with making infrastructure improvements to promote economic growth in the state, is funding one half of the cost of the upgrade in order to promote economic growth. In deciding to fund this particular project, the City E development authority is seeking to attract high technology companies to the area by assuring a reliable power supply for the manufacturing of technology related products. A private manufacturing company located in City E, Company F, is funding the other half of the circuit breaker costs. Company F uses approximately b percent of the power distributed through Substation D.

Taxpayer notes that the City E development authority will fund the circuit breakers through the issuance of tax increment bonds. Pursuant to state law, city and county municipalities in State A declare certain areas to be urban renewal areas. In turn, the Board of Directors of the City E development authority possesses the authority to recommend the creation of revenue allocation districts within any existing urban renewal area. In the present case, Substation D is located in the Urban Renewal Area G, a designated revenue allocation district.

The City E development authority will issue the bonds to finance certain improvements, including the circuit breaker project, payable solely from incremental increases, if any, in property taxes in the revenue allocation district. The incremental increases represent the difference between what the property tax would have been before improvement, compared to taxes assessed and collected by the city or county after the improvement (i.e., the taxes assessed on the increased value of the property).

Taxpayer asserts that while the payment for the circuit breakers will lead to more reliable electrical service to customers in Urban Renewal Area G, the upgrade will not result in new or additional capacity to customers. The Taxpayer further asserts the provision of more reliable electric service is an infrastructure improvement aimed at benefitting the area served by the Taxpayer as a whole by encouraging economic growth in the area.

LAW AND ANALYSIS

Section 61(a) and section 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 section 824(a) of the Tax Reform Act of 1986 (the 1986 Act) 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 contribution in aid of construction (“CIAC”) or any other contribution as a customer or potential customer.

Section 1.118-1 of the Income Tax Regulation provides, in part, that section 118 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 government 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 section 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 section 824 of the 1986 Act to section 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 such as the Taxpayer 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 is met: 1) the receipt of the properties 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 been 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, but rather relates to the benefit of the public as a whole. H.R. Rep. No. 426, 99th Cong., 1st Sess. 644-645 (1985), 1986-3 (Vol. 2) C.B. 644-645.

Notice 87-82, 1987-2 C.B. 389, provides additional guidance on the treatment of CIACs. Notice 87-82 provides examples of a governmental entity paying for utility services both as the primary beneficiary and also on behalf of third party customers. The Notice provides:

> For example, assume a utility receives a payment relating to the relocation or extension of utility facilities to a newly constructed municipal building (e.g., a public hospital, civic center, or museum)

> whose operations are conducted for the benefit of the community at large. Assume also that payment of the relocation fee was required in order to obtain utility services for the new building. Since the relocation fee is a prerequisite to the provision of services to the customer, the fee is a CIAC and included in gross income even though the customer is exclusively engaging in activities for the public benefit. Similarly, payments that are made to a utility as a prerequisite to the utility providing new or additional services to particular customers are treated as CIACs and included in gross income because such payments are a prerequisite to the provision of services by the utility, although a governmental entity may be making the payment in question (Notice 87-82, 1987-2 C.B. at 390, emphasis added).

In the instant case, the customers located in the Urban Renewal Area G will receive the benefit of more reliable electrical services resulting from City E development authority's payment to Taxpayer for upgrading Taxpayer's circuit breakers. We disagree with the Taxpayer's assertion that the phrase "new or additional services" in Notice 87-82 is limited to situations involving increased capacity. Rather, the term "new or additional services" includes an enhancement or upgrade of service of the type occurring in the present case (i.e., the provision of more reliable electrical service for utility customers). As Notice 87-82 provides, a payment resulting in new or additional services by a utility transferee to particular customers will constitute a CIAC, notwithstanding a governmental entity may be making the payment.

Based solely on the foregoing analysis and the representations made by the Taxpayer, we rule that the payment to Taxpayer by the City E development authority constitutes a CIAC under section 118(b) and therefore the payment cannot be considered a contribution to capital under section 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 the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy