Internal Revenue Service	Department of the Treasury

Number: **200317009**
Release Date: 4/25/2003
Index No.: 118.01-02
118.02-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:5 — PLR-150006-02
Date:
January 7, 2003

LEGEND

Taxpayer =

Corp =

Corp 2 =

Generator =

Power Marketer =

Agency =

State A =

State B =

City A =

City B =

Project =

b =

d =

e =

f =

g =

h =

i =

j =

k =

m =

n =

o =

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aa =

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ii =

jj =

Dear :

This letter responds to your letter dated September 9, 2002, submitted on behalf of Taxpayer, requesting a letter ruling concerning whether the transfer of an intertie from Generator to Taxpayer is a nonshareholder contribution to capital excludable from income under § 118(a) of the Internal Revenue Code.

FACTS

Taxpayer represents that the facts are as follows.

Generator is a State B limited liability company that was formed in aa, to develop, build, and own the Project. Generator is an indirect-wholly owned subsidiary of Corp. For federal income tax purposes, Generator is treated as a disregarded entity, and is considered a division of Corp 2, a first-tier subsidiary of Corp. Corp is a State B corporation that is both an operating company and a holding company that produces a wide range of industrial products. Corp files a consolidated federal income tax return for all companies in the affiliated group of which Corp is the common parent.

Taxpayer is a State A public utility that generates, purchases, transmits, distributes, and sells electricity and natural gas services in State A. Generator signed two contracts with Taxpayer in bb governing the interconnection of the Project to the grid. The Project is a b megawatt, natural-gas fired, simple-cycle power plant that went into commercial operation in jj. One of the contracts, the "Interconnection Agreement," is the legal document that permits Generator to connect to the grid. The other agreement, the "Expedited Interconnection Facilities Agreement," describes the intertie needed to connect the Project to the grid, allocates responsibility for constructing it, and makes Generator responsible for its cost.

Interconnection involved construction of a new radial line from the Project to an existing substation of Taxpayer, modification of the substation to accommodate the new line, installation of disconnect switches, circuit breakers, protective and control systems, meters, and a step-up transformer, construction of foundations, and rewiring and related tasks. (Taxpayer has submitted an exhibit showing the boundary where Taxpayer starts to own the Intertie.) Each party built the portion of the intertie on its side of the interconnection point, and Generator reimbursed Taxpayer for its costs.

The Interconnection Agreement will remain in effect until one party gives r days' written notice that it wants to terminate the agreement. Generator can give such notice for any reason. Taxpayer can only terminate after a premature termination of the Expedited Interconnection Facilities Agreement or if the Project has permanently ceased operating. Either party can terminate if the other has defaulted on its

obligations or if an uncontrollable force occurs and the parties are unable to identify a means of overcoming it within 12 months after notice by one party to the other of the event.

The Interconnection agreement requires Taxpayer to accommodate up to b megawatts of electricity from Generator on the grid. The agreement does not require Taxpayer to transmit or distribute the electricity. Generator is required to operate its power plant in a manner that maintains the integrity of the grid.

The Expedited Interconnection Facilities Agreement commits Taxpayer to design the intertie and divides up responsibility for constructing it. Taxpayer did the work on the part of the intertie that it owns. Generator built the intertie from the Project up to Taxpayer's property line and reimbursed Taxpayer for its costs. Generator had already advanced Taxpayer $d for the estimated cost of the work that the utility had to do by the time the Expedited Interconnection Facilities Agreement was signed in bb. The actual cost of Taxpayer's work was $e. Generator was given credit for $f that it spent on underground trenches that were conveyed to Taxpayer, and Taxpayer refunded $g to Generator in t. The amount Generator paid during s to reimburse Taxpayer for its anticipated costs and the underground trenches conveyed in kind are referred to as the interconnection payments. Taxpayer will be responsible for maintaining its portion of the intertie. Generator must pay an ongoing monthly maintenance charge.

Approximately r percent of the capacity of the Project has been committed to Agency under an amended power purchase agreement that was signed in u ("Power Purchase Agreement." Under the Power Purchase Agreement, Agency has first claim on the Project for an amount of electricity equivalent to hh hours of output at the rated capacity during peak periods and for electricity equivalent to ii hours at the rated capacity during other periods. The Power Purchase Agreement, has a term of j years from x when the Project commenced commercial operation. Under the Power Purchase Agreement, Agency makes monthly payments of approximately $m per megawatt/year for keeping the Project on standby. Agency may also purchase electricity from the Project up to the amount of capacity it has reserved by calling on the Project to produce. It must pay $n per megawatt/hour of electricity delivered and reimburse the Project for its fuel costs to generate the electricity. Agency has the option of supplying the fuel in lieu of paying fuel charges. The delivery point for electricity under the Power Purchase Agreement is at the interconnection point shown in a diagram submitted with the ruling request.

Generator entered into gg other contracts with Power Marketer dated as of ee. Power Marketer supplies fuel and helps market the electricity from the Project. These contracts run through ff, and remain in effect year to year thereafter unless terminated by either party. An Electricity Sales Scheduling and Marketing Agreement appoints Power Marketer as the scheduling agent for the Project and also provides that Power Marketer will recommend marketing strategies and financial and other risk management products for disposing of the remaining output. If Generator accepts the suggestions,

Power Marketer will implement them and receive compensation in addition to a scheduling fee. A Natural Gas Supply and Marketing Agreement makes Power Marketer responsible for procuring gas for the Project (to the extent not supplied by Agency). A Cross-Commodity Netting Agreement provides that any amounts Power Marketer owes the Project for electricity sales will be netted against the amounts it is owed for gas. The delivery point is the same delivery point for the sales to Agency.

Taxpayer represents that Generator will recover its basis using the straight-line method over 20 years. Taxpayer also represents that the intertie is equipped to carry backup power to generator. However, the parties expect that the amount of power flowing back over the intertie to Generator will be less than 5 percent of the projected power flows in both directions over the intertie during Taxpayer's first 10 tax years after the intertie is placed in service. Taxpayer will not put the intertie into its rate base.

LAW AND ANALYSIS

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, 2001-52 I.R.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, in part, 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, in part, 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, in part, 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 recovered 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) the Project is a stand-alone generator as contemplated under Notice 2001-82; (2) Generator and Taxpayer have 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; (4) the cost of the intertie will not be included in Taxpayer's rate base; (5) the amount of power flowing back over the intertie to Generator will be less than 5 percent of the projected power flows in both directions over the intertie during Taxpayer's first 10 tax years after the intertie is placed in service; (6) ownership of the electricity wheeled will not be with Generator prior to its transmission on the grid; and (7) 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 transfer 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 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.

Based on the facts presented, we conclude that 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. Therefore, the transfer of the intertie by Generator to Taxpayer will be a contribution to capital under § 118(a).

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer and Generator, we rule that the transfer of the intertie by Generator to Taxpayer will not constitute 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. Specifically, no opinion is expressed or implied on whether the agreement between Generator and Power Marketer is a sales contract or a service agreement. We are also not ruling as to whether your representation that less than 5 percent of the total projected power flows over the duel-use intertie from Taxpayer to Generator is a reasonable projection for purposes of the 5 percent test in Notice 88-129.

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)

Enclosure: 6110 copy