Internal Revenue Service

Number: **200403029**
Release Date: 01/16/2004
Index Number: 118.01-02, 118.02-00

Department of the Treasury
Washington, DC 20224

Person To Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B05 – PLR-110162-03
Date:
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LEGEND

Taxpayer =

Generator =

State A =

State B =

Company A =

Company B =

Company C =

Company D =

Affiliate =

Facility =

Interconnection Facilities =

Date 1 =

Date 2 =

a =

b =

Dear :

This letter responds to a letter submitted on behalf of Taxpayer dated February 7, 2003, requesting a letter ruling concerning whether the transfer of Interconnection Facilities to Taxpayer is a nonshareholder contribution to capital excludable from Taxpayer's income under § 118(a) of the Internal Revenue Code.

The relevant facts, as represented by Taxpayer are as follows:

FACTS

Taxpayer is a State A corporation engaged in the business of generating, transmitting, and distributing electrical energy to wholesale and retail customers predominantly in southeast State A. Taxpayer is a wholly-owned subsidiary of Company A and joins with Company A and various affiliates in filing a consolidated federal income tax return. Taxpayer uses the accrual method of accounting and a calendar taxable year.

Generator is a State B limited liability company that currently owns and operates Facility. Generator, an entity that is disregarded for federal income tax purposes, is wholly owned by another disregarded entity, Company B. Company B is wholly-owned by Company C. Company C files a consolidated return as a member of a consolidated group of which Company D is the parent. The consolidated group uses the accrual method of accounting and a calendar taxable year.

Taxpayer, a regulated utility, is required to accommodate a request from an independent power producer to interconnect the latter's generating facility to Taxpayer's transmission system. Any costs incurred by Taxpayer to complete the interconnection must be paid by the interconnecting independent power producer.

Generator is an independent power producer that owns and operates Facility. Facility commenced commercial operations on Date 2 and is expected to have a useful life of approximately a years. Facility is an exempt wholesale generator within the meaning of § 32 of the Public Utility Holding Company Act of 1935 and is not a qualifying facility (QF) under § 3 of the Federal Power Act, as amended by the Public Utility Regulatory Policies Act of 1978 (PURPA).

In order to sell the power produced at Facility, Generator requested interconnection to Taxpayer's transmission system. Taxpayer and Generator executed an interconnection agreement (IA), which was accepted for filing by the Federal Energy Regulatory Commission (FERC) on Date 1. The primary term of the IA is a years unless terminated earlier by mutual written agreement or upon default as described in the IA.

The IA required Generator to bear the cost of construction of Interconnection Facilities which will be owned at all times by Taxpayer. The total cost of the Interconnection Facilities was $b.

Generator has entered into an electric energy sales agreement with Affiliate, whereby Generator will sell the net output produced at Facility to Affiliate. Under this agreement, title to all power produced at Facility will pass to Affiliate at Generator's busbar before the power enters Taxpayer's transmission system. Accordingly, either Affiliate or another party, and not Generator, will arrange and pay for transmission service taken from Taxpayer.

Based on Generator's projections, during the first ten taxable years of the utility, beginning with the year Facility is placed in service, less than five percent of the projected total power flowing over the Interconnection Facilities will flow back to Facility. In addition, no component of the Interconnection Facilities is needed solely for transmission of power from Taxpayer to Generator.

In addition, Taxpayer represents that none of the costs for the Interconnection Facilities will be included in Taxpayer's rate base for regulatory purposes. Taxpayer also represents that it will not take any depreciation or amortization deductions with respect to the Interconnection Facilities.

Generator represents that it will amortize the cost of the Interconnection Facilities as an intangible asset, to be recovered using the straight-line method over a useful life of twenty years.

RULING REQUESTED

Taxpayer requests the Service to rule that the transfer by Generator to Taxpayer of the Interconnection Facilities is not a contribution in aid of construction (CIAC) under § 118(b), and is excludable from Taxpayer's gross income as a nonshareholder contribution to capital under § 118(a).

In addition to a ruling request as to whether the above described Interconnection Facilities qualify as a nonshareholder contribution to capital under § 118(a), Taxpayer also requests a ruling that amounts deposited by Generator with Taxpayer for the construction of transmission facilities upgrades constitute a loan or refundable deposit not includable in Taxpayer's gross income under § 61. As discussed with Taxpayer's authorized representatives on September 17, 2003, and September 29, 2003, the Service is declining to issue a ruling on this request.

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 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 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, 83d 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 CIAC 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) (Conference Report). 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 QF to a utility is to permit the sale of power by the QF 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 QFs to utilities.

Notice 88-129 provides, in part, that with respect to transfers made by a QF to a utility exclusively in connection with the sale of electricity by the QF to the utility, a utility will not realize income upon transfer of an intertie by a QF. An intertie may include new connecting and transmission facilities, or modifications, upgrades or relocations of a utility’s existing transmission network. 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 QF to another utility (wheeling) will not cause the contribution to be treated as a CIAC.

In the case of a dual-use intertie, Notice 88-129 provides that the contribution to a utility will be treated as a QF transfer if, in light of all information available to the utility at the time of transfer, it is reasonably projected that during the first ten taxable years of the utility, beginning with the year in which the transferred property is placed in service, no more than five percent of the projected total power flows over the intertie will flow to the QF.

Further, the notice provides, in part, that a transfer from a QF to a utility will not be treated as a 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.

Notice 88-129 also provides, in part, that a utility that constructs an intertie in exchange for a cash payment from a QF 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 QF 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 Interconnection Facilities 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 have entered into a long-term interconnection agreement with a term of <u>a</u> years; (3) the Interconnection Facilities will be used in connection with the transmission of electricity for sale to third parties (wheeling); (4) the cost of the Interconnection Facilities paid by Generator will not be included in Taxpayer's rate base; (5) Taxpayer will not take any depreciation or amortization deductions with respect to the Interconnection Facilities; (6) based on all available information, during the ten taxable years beginning with the year in which Facility is placed in service, no more than five percent of the total power flows over the Interconnection Facilities will flow to Generator; (7) ownership of the electricity wheeled passes to the purchaser prior to its transmission on Taxpayer's transmission grid; and (8) the cost of the Interconnection Facilities 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 Interconnection Facilities 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 transfer 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), 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 (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. Chicago, Burlington & Quincy Railroad Co., 412 U.S. at 413.

The transfer of the Interconnection Facilities by Generator to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the Interconnection Facilities will become a permanent part of Taxpayer's working capital structure. Second, the transfer is not compensation for services provided 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 Interconnection Facilities will become a part of Taxpayer's transmission system. Fifth, the Interconnection Facilities will be used by Taxpayer in its trade or business for producing gross income. Therefore, Taxpayer's receipt from Generator of the Interconnection Facilities 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 Interconnection

Facilities 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. Specifically, no opinion is expressed or implied as to whether the parties' representation that less than five percent of the total projected power flows over the interconnection facilities from Taxpayer to Facility is a reasonable projection for purposes of the five-percent test in Notice 88-129. In addition, no opinion is expressed or implied as to whether the payments by Generator to Taxpayer for the construction of the transmission facilities upgrades constitute a loan or refundable deposit.

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

cc: