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Date:
July 19, 2004

In Re:

Legend:

Taxpayer =

State =

Dear :

This letter responds to a letter dated March 24, 2004, and subsequent correspondence, submitted on behalf of Taxpayer, requesting a ruling under § 118 of the Internal Revenue Code.

FACTS

Taxpayer is a regulated natural gas distribution utility that owns a gas distribution system and related facilities in State. Taxpayer provides distribution services to gas marketers serving residential, commercial, and industrial consumers in State. Taxpayer's activities include distributing natural gas for gas marketers, maintaining the gas system infrastructure (including maintaining gas pipes and responding to gas leaks), and performing meter reading for the marketers.

With the deregulation of the natural gas industry, Taxpayer is no longer permitted under State law to sell natural gas to consumers or charge consumers for distribution services. Consumers contract with gas marketers to receive natural gas. The gas marketers purchase natural gas from production companies and pay Taxpayer for distribution of the natural gas from the point of delivery by the production companies to

the premises of the marketers' customers. At all times, the gas marketers, and not Taxpayer, own the gas being transported by Taxpayer's distribution system.

As a regulated utility, Taxpayer enters into a ratemaking process with the State Public Service Commission ("PSC") pursuant to which Taxpayer and the PSC negotiate Taxpayer's tariff. The tariff essentially establishes the services that Taxpayer must provide, including extension policies, and the rates that Taxpayer may charge. Under the tariff, Taxpayer generally is obligated to extend its gas distribution system when Taxpayer receives an extension application.

Under State law, the PSC is required to establish for each electing distribution company a universal service fund to enable the distribution company to expand its facilities in the public interest. The USF is funded in part from rate refunds from the electing distribution company's interstate pipeline suppliers, certain specified earnings of the electing distribution company, and surcharges to rates for service of the electing distribution company. Any amount remaining in the USF at the end of a fiscal year is available for refund to retail customers at the discretion of the PSC.

Upon receipt of an extension application, Taxpayer performs an economic analysis to determine the project's viability (the cost of the extension versus Taxpayer's expected return on the extension). Taxpayer's investment in the extension cannot exceed the expected return on the extension ("allowable investment"). If the cost of the extension exceeds Taxpayer's allowable investment, the natural gas consumer or the real estate developer may contribute the excess amount and may request that the USF assist it in making the contribution. If Taxpayer receives a contribution from the natural gas consumer, the real estate developer, or the USF to cover the excess costs of the extension or if the cost of the extension does not exceed Taxpayer's allowable investment, Taxpayer must grant the extension application.

Taxpayer will receive payments from natural gas consumers, real estate developers, and the USF to fund the extension of Taxpayer's gas distribution lines to new locations.

Taxpayer requests a ruling that contributions by natural gas consumers, real estate developers, and the USF to Taxpayer are not contributions in aid of construction ("CIACs") under § 118(b) and are excludable from the gross income of Taxpayer as 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) provides that for purposes of § 118(a), except as provided in § 118(c) 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.

Regarding § 118(b), H.R. Rep. No. 426, 99th Cong., 1st Sess. 643-45 (1985) states the following:

> The committee believes that all payments that are made to a utility either to encourage, or as a prerequisite for, the provision of services should be treated as income of the utility and not as a contribution to the capital of the utility.
>
> The committee intends that the effect of the change is to require that a utility report as an item of gross income the value of any property, including money, that it receives to provide, or encourage … the provision of, services to or for the benefit of the person transferring the property. A utility is considered as having received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of the services, if 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 if the receipt of the property otherwise causes the transferor to be favored in any way.
>
> The person transferring the property will be considered as having been benefited if he is the person who will receive the services, an owner of the property that will receive the services, a former owner of the property that will receive the services, or if he derives any benefit from the property that will receive the services. Thus, a builder who transfers property to a utility in order to obtain services for a house that he was paid to build will be considered as having benefited from the provision of the services. This will be the case despite the fact that the builder may never have had an ownership interest in the property and may make the transfer to the utility after the house has been completed and accepted.

Notice 87-82, 1987-2 C.B. 389, states the following:

> [P]ayments 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 payments in question.

Taxpayer believes that because the natural gas consumers, the real estate developers, and the USF do not purchase natural gas from Taxpayer or pay for distribution services from Taxpayer, they are not customers of Taxpayer. Accordingly, their contributions cannot be CIACs under § 118(b).

The natural gas consumers and real estate developers are making the contributions to Taxpayer because they want natural gas service extended to their location. Gas service includes the distribution of the natural gas as well as the marketing of the natural gas. The contributions made to Taxpayer will enable Taxpayer to extend its distribution system to the area in need of service. Extension of Taxpayer's distribution system is a prerequisite to the marketing of natural gas to the new gas consumers. Both the natural gas consumers and the real estate developers derive a benefit from the receipt of gas service in making the contribution to Taxpayer.

Regarding the contributions by the USF, Notice 87-82 provides that contributions made by a governmental entity to a utility are CIACs if the contributions are a prerequisite to new or additional services to particular customers. The contributions by the USF to Taxpayer are a prerequisite to the receipt of natural gas service by natural gas consumers at the new locations.

CONCLUSION

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer, we conclude that the contributions by natural gas consumers, real estate developers, and the USF to Taxpayer are contributions in aid of construction under § 118(b) and, therefore, are not excludable from the gross income of Taxpayer as nonshareholder contributions 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.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) 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