Internal Revenue Service

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LEGEND

Taxpayer	=
Parent A	=
Parent B	=
Subsidiary	=
Generator	=
Administration	=
ISO	=
Substation A	=
Substation B	=

State	=	
City	=	
Address	=	
Impact Study	=	
Facility Study	=	
System Facilities Agreement	=	
Amendment	=	
Tariff	=	
Date 1	=	
Date 2	=	
Date 3	=	
Year	=	
b	=	
c	=	
d	=	

Dear :

This letter responds to Taxpayer's authorized representative's letter dated September 3, 2003, submitted on behalf of Taxpayer, requesting a letter ruling concerning whether the transfer of an intertie by Generator to Taxpayer will be a nonshareholder contribution 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. Taxpayer's primary business is the generation and transmission of electricity. Taxpayer is a wholly owned subsidiary of Parent A, a State corporation. Parent A is a registered holding company under the Public Utility Holding Company Act of 1935, as amended. Taxpayer is a member of the consolidated group for federal income tax purposes of which Parent A is the common parent.

Generator is a stand-alone generator (SAG) wholly owned by Subsidiary, a wholly owned subsidiary of Parent B. Generator is constructing a b MW natural gas-fired power generator facility (Facility) within Taxpayer's service area at Address. Taxpayer's service area includes the c square-mile area of central, coastal, and southern State, excluding City and certain other cities. Pursuant to the Federal Energy Regulatory Commission (FERC) Order No. 888, regulated public utilities such as Taxpayer must allow SAGs to interconnect to the transmission grid so that the SAGs can sell or "wheel" power over the transmission grid for delivery to customers or other intermediaries (collectively, Customers).

Generator intends to interconnect the Facility with the transmission system owned by Administration by interconnecting a new substation that Generator intends to have constructed (Substation A) with Administration's Substation B. Taxpayer also interconnects with Administration's transmission systems at Substation B. Pursuant to Generator's request, Taxpayer performed a study under the terms of the Impact Study, dated Date 1, to determine the impacts of Generator's interconnection with administration on Taxpayer's system and to determine the measures needed to mitigate those impacts.

The results of the Impact Study found that the interconnection of the Facility with Administration would adversely impact Taxpayer's transmission system and that network upgrades would be required to mitigate such impact. The result of the Impact Study also indicated the need to perform a facilities study to determine the facilities, equipment modifications, or additions that may be required in order to permit the interconnection of the Facility to Administration. Taxpayer subsequently performed and completed the Facility Study dated Date 2. The Facility Study specified the facilities, equipment modifications, and additions required to interconnect the Facility to Administration's transmission system.

Taxpayer required Generator to pay for the required design, engineering, and construction costs for all transmission lines, substations, modifications, and network system upgrades (Intertie) specified in the Facility Study and the Systems Facilities Agreement (SFA) dated Date 3 necessary to safely and reliably interconnect the Facility in order to permit the sale of power produced by the Facility to Generator's Customers.

Taxpayer designed, engineered, constructed, and owned the Intertie and was reimbursed for all related costs and expenses by Generator. The estimated cost of the Intertie totaled $d.

The Facility is anticipated to commence commercial operations in Year and physically interconnect to Administration's grid at that time. The electricity produced at the Facility will be primarily sold, or wheeled, to customers in the wholesale power market. Ownership and title to the electricity produced by the Facility and sold to Generator's Customers will be transferred to its Customers prior to the transmission of the electricity onto Administration's transmission grid. Specifically, title to the electricity will pass to the customers at the Bus located on the Facility side of the point of interconnection at Substation A. That is, title to the electricity will pass to Generator's Customers prior to the transmission of the electricity onto Administration's or Taxpayer's transmission grids.

Additionally, Administration was interconnected to Taxpayer's transmission grid by a dual-use interconnection that allows electricity to flow back in the direction of Administration. However, at the time the Intertie was deemed transferred to Taxpayer, Generator reasonably projected that no more than 5 percent of the projected total power that flows over this interconnection would flow in the direction of the Facility during the first ten taxable years of operation, beginning with the year in which the Intertie is placed in service.

The deemed transfer of the Intertie was made pursuant to the SFA. The SFA has a 30-year term, subject to certain termination provisions.

Taxpayer did not include the costs of the Intertie in the regulatory rate base upon which its rates are determined under standard cost-based rate regulation. Generator represents that it capitalized the cost of the Intertie as an intangible asset, recovering such costs using the straight-line method of depreciation over a useful life of 20 years.

Generator, as the sole project sponsor of the Intertie, may be eligible to receive from the ISO firm transmission rights, wheeling revenues, and congestion revenues attributable to the increased incremental transmission capacity provided by the Intertie (System Upgrade Rights). Under the ISO Tariff, the ISO, a quasi-governmental authority, controls and manages the grid and entitlements thereto, and is entirely independent of both Generator and Taxpayer. Furthermore, the ISO acts as the authority that issues the rights and interests in any system upgrades to the ISO transmission system. Pursuant to the Amendment, the ISO requested and was granted the authority to issue to Generator the System Upgrade Rights.

The System Upgrade Rights are assets owned by Generator independent of Taxpayer. Moreover, the System Upgrade Rights were never rights owned or ever held by Taxpayer. Pursuant to the Amendment, Taxpayer was never in receipt of the System Upgrade Rights, nor did Taxpayer have a right to demand them from the ISO or from Generator.

Taxpayer further represents that the characteristics described below are present with respect to the deemed transfer of the Intertie by Generator to Taxpayer. First, the Intertie paid for by Generator will become a permanent part of Taxpayer's transmission system. Second the payment by Generator for the costs of the design, engineering, and construction of the Intertie was not compensation for services provided by Taxpayer to Generator. Rather, the payment by Generator to Taxpayer was necessary to permit the Facility to safely interconnect to Administration and for Generator to sell power produced by the Facility to its customers. Third, the construction of the Intertie and the subsequent payment for the costs of design, engineering, and construction was a bargained for exchange because Taxpayer and Generator negotiated and entered into the necessary agreements willingly and at arms length. Fourth, the Intertie will foreseeably result in a benefit to Taxpayer commensurate with its value because the Intertie is part of Taxpayer's transmission system. Fifth, the Intertie will be used by Taxpayer in its transmission business to produce income.

RULINGS REQUESTED

Taxpayer requests the Service to rule that the deemed transfer of the Intertie by Generator to Taxpayer 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).

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, 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 the Public Utilities Regulatory Policies Act of 1978 (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) (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 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 an intertie by a Qualifying Facility. 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 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.

Notice 88-129 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 deemed 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 Facility 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 (wheeling); (4) the cost of the Intertie will not be included in Taxpayer's rate base; (5) the Intertie is a dual-use intertie; however, it is projected that during the first ten taxable years of the Facility, no more than 5 percent of the projected total power flows over the Intertie will flow to Generator; (6) it is represented that Generator will not own the electricity prior to its transmission on Taxpayer's transmission 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 deemed 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 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 deemed 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. First, the Intertie paid for by Generator will become a permanent part of Taxpayer's transmission system. Second the payment by Generator for the costs of the design, engineering, and construction of the Intertie was not compensation for services provided by Taxpayer to Generator. Rather, the payment by Generator to Taxpayer was necessary to permit the Facility to safely interconnect to Administration and for Generator to sell power produced by the Facility to its customers. Third, the construction of the Intertie and the subsequent payment for the costs of design, engineering, and construction was a bargained for exchange because Taxpayer and Generator negotiated and entered into the necessary agreements willingly and at arms length. Fourth, the Intertie will foreseeably result in a benefit to Taxpayer commensurate with its value because the Intertie is part of Taxpayer's transmission system. Fifth, the Intertie will be used by Taxpayer in its transmission business to produce income. Therefore, Taxpayer's receipt from Generator of the Intertie is a contribution to capital under § 118(a).

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer and Transferor, we rule that the deemed transfer of the Intertie by Generator to Taxpayer is not a CIAC under § 118(b) and is 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 Taxpayer's representation that less than 5 percent of the total projected power flows over the Intertie from Taxpayer to Generator is a reasonable projection for purposes of the 5 percent test in Notice 88-129.

In accordance with the power of attorney on file with this request, we are sending copies of this letter ruling to Taxpayer's first and second authorized representatives.

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,

Susan J. Reaman
Chief, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy

CC: