**Internal Revenue Service**

Number: **200747008**
Release Date: 11/23/2007

Index Number: 118.00-00, 118.01-02

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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Refer Reply To:
CC:PSI:B05
PLR-118533-07

Date:
August 28, 2007

**LEGEND**

Taxpayer =

State =

Parent Company =

Commission A =

Act =

Commission B =

Bank =

Date 1 =

Date 2 =

Date 3 =

a =

b =

c =

d =

e =

f =

Dear :

This letter responds to a letter submitted on behalf of Taxpayer dated April 16, 2007, concerning the proper treatment of certain amounts to be received from State in connection with the recovery of costs incurred by Taxpayer to repair and rebuild its electric system in the aftermath of , to construct a new regional center, and to establish financial reserves for future

Taxpayer represents that the relevant facts are as follows:

## FACTS

Taxpayer is a vertically-integrated, cost-based, rate-regulated electric utility providing retail electric utility service in State. Taxpayer, a State corporation, is a wholly owned subsidiary of Parent Company. Parent Company and its subsidiaries, including Taxpayer, file a consolidated federal income tax return on the accrual method of accounting and on a calendar year basis.

Taxpayer is regulated by Commission A. Taxpayer's costs incurred in the provision of electric utility service, net of payments received from other sources, are recovered through Taxpayer's retail electric rates pursuant to public utility cost-of-service retail ratemaking. Taxpayer's wholesale sales of electricity, as well as its provisions of electric transmission service, are regulated by the Federal Energy Regulatory Commission.

Taxpayer owns or leases all or a portion of certain electric generating facilities and owns extensive electric transmission lines within State. Taxpayer also services certain REA-financed electric cooperatives.

Taxpayer's system was damaged by in . Taxpayer's total estimated cost of restoring the damage to its system is $a, net of insurance proceeds.

Additional funds in the amount of $b will be necessary in order to construct a new regional center and to restore its damage reserve.

On Date 1, the Act was enacted into law in State. The Act establishes a mechanism by which Commission A can authorize and certify an electric utility financing order and State can issue general obligation bonds to fund the costs incurred or to be incurred to repair damage to electric utility systems caused by . Pursuant to the Act, affected electric utilities can petition Commission A for an irrevocable financing order which, upon receipt, would be transmitted by the utility to Commission B. Commission B will issue system restoration bonds that will be acquired by Bank from proceeds of Bank's special obligation bonds issued to the general public. The proceeds of the bonds would be used by the utility for costs incurred or to be incurred to repair system damage or create financial reserves for damages caused by future

Proceeds of the system restoration bonds will be deposited into a special fund separate and apart from the general fund of State. Expenditures from the special fund are paid by State's treasurer to the requesting utility upon warrants issued by Commission A after approving requisitions submitted by the electric utilities.

Once a financing order and the system restoration bonds are issued as described above, Taxpayer will bill to, and collect from, its customers the system restoration charge authorized by Commission A. The Act requires that these charges be deposited by Taxpayer into a sinking fund in the manner mandated by State's treasurer. The money in each sinking fund established for Taxpayer pursuant to the Act will be used to pay the principal and interest on the system restoration bonds issued by State under Commission A's financing order. Any unexpended funds in the sinking fund after the retirement of the associated system restoration bonds will be credited to the general fund of State.

On Date 2, Commission A issued an order certifying the prudency of $a of Taxpayer's restoration costs. On Date 3, Commission A issued its financing order authorizing the system restoration charge in the amount of $c. This amount represents $d of restoration costs in excess of certain federal and state emergency funding, $e to fund the retail portion of the new regional center, and $f to establish and replenish Taxpayer's property damage reserve. State will be fully repaid for expenditures authorized by State's treasurer, plus interest. Taxpayer's own customers (the rate-paying public) bear the ultimate burden of the cost of restoring the damage to Taxpayer's generation, distribution, and transmission systems caused by . Taxpayer is required to service the charge on its bills and then pay the money over to State for the payment of principal and interest on the bonds authorized to be issued pursuant to the Act.

## RULINGS REQUESTED

Taxpayer requests the Service to rule that:

(1) Taxpayer will not recognize taxable income upon: (a) the issuance by Commission A of a financing order creating an intangible property right in the amount of the specified costs that may be recovered through the securitization of the system restoration property; or (b) the receipt of money or other valuable consideration from State upon its issuance of securitized instruments to the public.

(2) Payments by State to Taxpayer pursuant to the Act for building a new regional center and restoring Taxpayer's damage reserve qualify as non-shareholder contributions to Taxpayer's capital under § 118. The basis of any property acquired by Taxpayer with the funds contributed by State pursuant to the Act will be accounted for in accordance with § 362(c).

## LAW AND ANALYSIS

### First ruling request

Revenue Procedure 2007-3, 2007-1 I.R.B. 108, 109, section 3.01(3) provides, in part, that the Service will not issue rulings in circumstances involving any investor-owned utility seeking cost recovery through (i) the creation of an intangible property right; (ii) the transfer of that intangible property right; or (iii) the securitization of the intangible property right. The transaction in the instant case involves two of the three elements of the above-quoted revenue procedure and we are, therefore, compelled to decline ruling on Taxpayer's first request above.

### Second ruling request

In order to respond to Taxpayer's second ruling request, we must first assume that the payments by State to Taxpayer are includible in gross income under § 61. Because § 118 is an exclusion from gross income, we are unable to reach the relevant analysis without there first being items that would be includible in gross income in the absence of § 118.

Section 61(a) generally defines gross income as income from whatever source derived unless excluded by law. Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income realized in any form, whether in money, property, or services.

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 1.118-1 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).

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.

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. The Court stated that:

> It seems fair to say that neither in Detroit Edison nor in Brown Shoe did the Court focus upon the use to which the assets transferred were applied, or upon the economic and business consequences for the transferee corporation. Instead, the Court stressed the intent or motive of the transferor and determined the tax character of the transaction by that intent or motive. Thus, the decisional distinction between Detroit Edison and Brown Shoe rested upon the nature of the benefit to the transferor, rather than to the transferee, and upon whether that benefit was direct or indirect, specific or general, certain or speculative. These factors, of course, are simply indicia of the transferor's intent of motive.

412 U.S. 401, 411 (1973).

The Court reconciles Detroit Edison and Brown Shoe on the ground that in the former the transferor intended no contribution to the transferee's capital, whereas in the latter the transferors did have that intent. See Id. at 412.

In the instant case, State did not intend to make a nonshareholder contribution to Taxpayer's capital. This lack of intent is demonstrated by the fact that Taxpayer's own customers are paying for the new center and restoration of Taxpayer's damage reserve. State intended to have its investment repaid, plus interest. To achieve this, State developed a financing mechanism for Taxpayer to recover the costs from its customers.

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer, we rule that payments by State to Taxpayer pursuant to the Act for building a new regional center and restoring Taxpayer's damage reserve do not qualify as non-shareholder contributions to Taxpayer's capital under § 118. Therefore, the basis provisions of § 362(c) do not apply.

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, we express no opinion on

whether the payments by State to Taxpayer constitute gross income under § 61, nor do we express an opinion on whether the payments are a loan for federal tax purposes.

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,

/s/ Paul F. Handleman

Paul F. Handleman
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Enclosure: 6110 copy