Internal Revenue Service

Department of the Treasury

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Index Nos.: 118.02-00
118.03-00
Number: **199920027**
Release Date: 5/21/1999

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:5 — PLR-119320-98
Date:
Feb 18 1999

In re: Request for Private Letter Ruling under § 118(a) and (b) of the Internal Revenue Code

Legend:

Taxpayer =

Subsidiary =

Government =

State X =

District =

a =

b =

c =

d =

Dear :

This letter responds to your letter dated October 6, 1998, requesting a ruling regarding whether the transfers of electrical distribution systems and other amounts by the Government to Subsidiary under a privatization program constitute contributions in aid of construction under § 118(b) of the Internal Revenue Code.

The Taxpayer has made the following representations:

Subsidiary is a wholly owned subsidiary of the Taxpayer and a member of the Taxpayer's affiliated group. The Taxpayer is a holding company. Subsidiary is a regulated public utility within the meaning of § 7701(a)(33) and is in the business of generating, transmitting, and distributing electric power in State X and other states. The members of the Taxpayer affiliated group file a consolidated federal income tax return on a calendar year basis using the accrual method of accounting. The Taxpayer affiliated group is subject to the audit jurisdiction of the District Director for the District.

Subsidiary provides electrical services including distribution services to customers in its service territory. A limited number of large customers, including the army installations consisting of the Government, maintain their own distribution systems. They purchase power from the local utility and then distribute the power within their facilities. The local utility provides power to a master metering point where the customer takes title and responsibility for the electrical energy.

The Taxpayer represents that the government's master metering service arrangement evolved for a number of reasons. When first operational, many of the installations were located in rural or remote areas that did not yet have extensive local public utility distribution infrastructures. The army's ownership of the systems was needed to assure the provision of safe and reliable utility services to meet an installation's important national defense requirements. Many of the installations were either opened or greatly expanded during or just after World War II and then expanded again during the early years of the Cold War. According to the Taxpayer, during these sensitive times, government ownership of utility distribution systems was preferred in order to reduce an installation's vulnerability to sabotage and other threats.

The rationale for continued government ownership of utility systems changed in the 1990s due to a combination of a changing defense mission with the end of the Cold War and limited financial and other resources. According to the Taxpayer, the consequences of government ownership of utility distribution systems were the habitual under funding of operation and maintenance requirements, difficulty in obtaining equipment, repair parts for specialized equipment not being stocked, and difficulty in finding skilled staff. Deferred system maintenance created a risk to the military's mission and to the public safety.

In a, the Department of the Army decided that ownership and operation of the utility systems should be privatized. The army describes privatization as the transfer of ownership, operation and maintenance, and system upgrade responsibilities to the non-federal sector. Because ownership of utility systems is not a core function of the army, transferring utility distribution system ownership to the non-federal sector would secure the financial and other resources necessary to upgrade and properly maintain the systems. Related efficiencies were expected to result in cost savings and improved reliability.

In b, the Department of Defense announced a program of privatization reform. The Defense Reform Initiative calls for the privatization by c of all electric, natural gas, water, and wastewater utility systems, except those need for unique security reasons or when privatization is not economical. The Department of Defense obtained statutory approval for its privatization policy.

Section 2688(a) of the National Defense Authorization Act for Fiscal Year 1998 (the "Act") provides that the Secretary of a military department may convey a utility system, or part of a utility system, under the jurisdiction of the Secretary to a municipal, private, regional, district, or cooperative utility company or other entity. The conveyance may consist of all right, title, and interest of the United States in the utility system or such lesser estate as the Secretary considered appropriate to serve the interests of the United States.

Section 2688(c)(1) of the Act provides that the Secretary concerned shall require as consideration for a conveyance under section 2688(a) an amount equal to the fair market value (as determined by the Secretary) of the right, title, or interest of the United States conveyed. The consideration may take the form of (A) a lump sum payment; or (B) a reduction in charges for utility services provided by the utility or entity concerned to the military installation at which the utility system is located.

Section 2688(e)(1) of the Act provides that the Secretary concerned may not make a conveyance under section 2688(a) until the Secretary submits to the Committee on Armed Services and the Committee on Appropriations of the Senate and the Committee on National Security and the Committee on Appropriations of the House of Representatives an economic analysis (based upon accepted life-cycle costing procedures approved by the Secretary of Defense) demonstrating that (A) the long-term economic benefit of the conveyance to the United States exceeds the long-term economic cost of the conveyance to the United States; and (B) the conveyance will reduce the long-term costs of the United States for utility services provided by the utility system concerned.

The army installations consisting of the Government own, operate, and maintain electrical distributions systems. The Government purchases electricity for these installations from Subsidiary. The installations are all located in State X and within Subsidiary's service territory.

The army is pursuing privatization of its electric installations to comply with the Defense Reform Initiative. Because additional base realignment and closure initiatives may occur, the cost of utility services are a factor in determining the mission of the bases and which bases will remain operational. The army installations consisting of the Government are considered vital to the economies of the surrounding areas. The Taxpayer emphasizes that privatization is viewed as providing for the public safety within the installations. Under funding of maintenance has posed a hazard to the public. The Taxpayer asserts that public safety was a major impetus for privatization particularly after ineffective maintenance at one installation caused a natural gas explosion.

Pursuant to the Defense Reform Initiative and the Act, the army will transfer ownership of the army installations consisting of the Government electrical distribution systems facilities to Subsidiary for the nominal price of $d. Subsidiary will assume responsibility for operating the systems by distributing electricity to each of the buildings on the Government installations. Subsidiary would continue to provide for electric commodity sales to a single master-metered delivery point. The Taxpayer represents that there would be no change in the nature, price, or volume of electrical services provided to the Government installations. Subsidiary will not include the contributed facilities in its rate base. Subsidiary will recover its ongoing cost to provide electrical distribution services to the Government installations pursuant to a special service agreement.

The Taxpayer requests a ruling that the transfers of electrical distribution systems and other amounts by the Government to Subsidiary under a program to privatize electrical distribution systems represent contributions to capital of Subsidiary under § 118(a) and are not contributions in aid of construction ("CIAC") under § 118(b) of the Code.

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 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 states 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 states 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).

In general, the amendment made by § 824 of the Tax Reform Act of 1986 (the "1986 Act") to § 118 was intended to require a regulated public utility to include in income the value of any CIAC made to encourage the provision of services by the utility to a customer. As a result under the 1986 Act, all CIACs, even those received by a regulated public utility such as Subsidiary, are includible in the gross income of the receiving corporation. The House Ways and Means Committee Report (the "House Report") states that property, including money, is a CIAC, rather than a contribution to capital, if it is contributed to provide or encourage the provision of services to or for the benefit of the person making the contribution. H.R. Rep. No. 426, 99th Cong., 1st. Sess. 644 (1985); 1986-3 (Vol. 2) C.B. 644.

A utility is considered as having received property to encourage the provision of services if any one of the following conditions are met: (1) the receipt of the property is a prerequisite to the provision of the services; (2) 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 (3) the receipt of the property otherwise causes the transferor to be favored in any way. The House Report also states that the repeal of the special exclusion does not affect transfers of property that are not made for the provision of services, including situations where it is clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfers. House Report at 644-45; 1986-3 (Vol. 2) C.B. at 644-45.

Notice 87-82, 1987-2 C.B. 389, provides additional guidance on the treatment of CIACs. Notice 87-82 follows the language from the House Report and states that a payment received by a utility that does not reasonably relate to the provision of services by the utility or for the benefit of the person making the payment, but rather relates to the benefit of the public at large, is not a CIAC. In Notice 87-82, an example of a payment benefitting the public at large is a relocation payment received by a utility under a government program to place utility lines underground. In that situation, the relocation is undertaken for either reasons of community aesthetics or in the interest of public safety and does not directly benefit particular customers of the utility.

The Taxpayer argues that the proposed transfers of the Government electrical distribution systems to Subsidiary should not be treated as CIACs under § 118(b) because the transfers are not a prerequisite to the provision of services; the army is already receiving electrical services from Subsidiary. The transfers will not cause the army to be favored in any way because Subsidiary does not anticipate an increase in electric commodity sales attributable to the transfers. The Taxpayer concludes that the

House Report and Notice 87-82 stand for the proposition that transfers which do not result in new or expanded utility services are not CIACs under § 118(b).

The Taxpayer also strongly contends that the proposed transfers will benefit the public at large because the primary motive for the transfers is for public safety. The army is making the transfers because it lacks the resources to properly operate the Government distribution systems without creating a risk to the army, contractor personnel, and the general public that routinely visit the Government installations. The Taxpayer has enumerated instances were the under funding of operation and maintenance costs have created hazardous conditions. The Taxpayer concludes that the proposed transfers are not CIACs because the transfers satisfy the public benefit exception contained in the House Report and Notice 87-82.

In order for the proposed transfers not to be treated as CIACs under § 118(b), the army must not be receiving new or expanded utility services and the transfer by the army must satisfy the public benefit exception contained in the House Report and Notice 87-82. We do not agree with the Taxpayer that the army will not be receiving new or expanded utility services from Subsidiary. The army is a customer of Subsidiary that is making contributions to Subsidiary in its capacity as a customer. Though Subsidiary will not provide increased electric commodity sales to the army for the Government installations, Subsidiary will be providing new and expanded electrical distribution services on the installations, for which it will receive separate compensation under a special service agreement. In addition, we do not agree with the Taxpayer that the proposed transfers satisfy the public benefit exception.

The Taxpayer and the army have provided numerous examples where the under funding of operation and maintenance have created safety problems on army installations. However, section 2688(e)(1) of the Act clearly demonstrates that Congress intended that the privatization must be for the long-term economic benefit of the United States which is defined as reducing long-term costs to the United States for utility services. The Taxpayer has been unable to find any authority in the legislative history of the Act demonstrating that the Congress' primary motive in enacting the Act was safety concerns, not economic benefits to the United States. It appears that the army had the choice of spending more money for operation and maintenance, or contracting with Subsidiary for those services. Subsidiary may perform those services more efficiently with or without owning the distribution systems. However, the army is making the contributions in its capacity as a customer and will be receiving Subsidiary's distribution services.

Accordingly, based on the representations of the Taxpayer, we rule that the proposed transfers of the Government electrical distribution systems to the Subsidiary are CIACs under § 118(b). Therefore, the contributions of the Government electrical distribution systems do not qualify as nonshareholder contributions to capital to Subsidiary 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 yours,

/s/ Walter H. Woo
WALTER H. WOO
Senior Technician Reviewer,
Office of Assistant
Chief Counsel
(Passthroughs and Special
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Enclosure:
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