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Department of the Treasury

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Person to Contact:

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Refer Reply To:
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Date:
November 27, 2002

LEGEND

Taxpayer =

Generator =

Company A =

Company B =

Company C =

Company D =

Company E =

State A =

State B =

City =

County =

System =

Grid =

Year 1 =

Year 2 =

Year 3 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Transmission Line	=
Substation A	=
Substation B	=
Substation C	=
Substation D	=
Substation E	=
b	=
c	=
d	=
e	=

Dear :

This letter responds to Taxpayer's letter dated July 31, 2002, requesting a letter ruling concerning whether the transfer of an intertie by Generator to Company B is a nonshareholder contribution to capital excludable from Taxpayer's income under § 118(a) of the Internal Revenue Code.

Taxpayer represents that the facts are as follows:

FACTS

Taxpayer, a State A corporation, is an independent power company. Taxpayer is the parent of a group of affiliated corporations filing a consolidated return for federal income tax purposes. Taxpayer is a calendar year taxpayer and employs the accrual method of accounting.

Company A and its subsidiary, Company B, are both State B corporations. Prior to Date 1, Company B was a member of the consolidated group of corporations of which Company A was the parent. On Date 1, Taxpayer acquired Company A. Accordingly, Company A will file a short-form return for the year ending Date 1. Subsequent to filing that short-form return, Company A and Company B will be members of the consolidated federal income tax return filed by Taxpayer.

Company A is the holding company for Company B and Company C, which generates, transmits, distributes, and sells electricity. Company B is a regulated electric utility located in City. Company B provides retail electric service to residential, commercial, and industrial customers in City, as well as portions of other central State B communities surrounding County. Company B owns and maintains the System for the transmission of electricity. The System connects with the electric grid system.

Generator is a State A limited partnership, and was formed to develop, construct, own, operate, and maintain a gas-fired electric generating facility in City (Facility), which supplies peaking power to the Grid. The Facility consists of three gas combustion turbine units (GT2, GT3, GT4), each with a nominal rated capacity of 80 megawatts, and associated transformer equipment and facilities.

Generator constructed the Facility near certain substation facilities and transmission lines owned by Company B (Substation A). The Facility was constructed in two phases. In the first phase, Generator installed GT2 and GT3 on property adjacent to Substation A. Those units began commercial operations on Date 2. In the second phase, Generator installed GT4, which began commercial operations on Date 3. In connection with developing the Facility, Generator sold a gas combustion turbine unit (GT1) to Company B. The GT1 generating facility was installed near Substation A at the same time as GT2 and GT3.

Company B and Generator entered into an Interconnection, Maintenance, and Operation Agreement, effective as of Date 4, to enable Generator to interconnect the Facility with the System for the purpose of selling power to Company B and to third parties. This agreement originally addressed the interconnection of GT2 and GT3 to the System. On Date 5, Company B and Generator entered into an Amendment to the Interconnection Agreement (the Interconnection, Maintenance, and Operation Agreement, as amended, is hereinafter referred to as the Interconnection Agreement) to provide for the interconnection of GT4 to the System. The Interconnection Agreement addresses the following three sets of equipment.

The Interconnection Agreement provides that Company B would, at its own expense, construct new interconnection equipment and upgrade existing interconnection facilities (Subsidiary Interconnection Facilities) at Substation A. The Subsidiary Interconnection Facilities include improvement to the Transmission Line and Substation B.

Further, the Interconnection Agreement provides that Company B will construct certain facilities (Joint Interconnection Facilities) that would interconnect the Facility with the Subsidiary Interconnection Facilities. The Joint Interconnection Facilities include two 138 kV breakers and a 138 kV bus that connects the breakers to the Subsidiary Interconnection Facilities and to the Facility generator step-up transformer disconnect switches. Capacity for the Joint Interconnection Facilities is allowed three-fourths to Generator and one-fourth to Company B, and the costs of the Joint Interconnection Facilities were borne according to the same ratio. The Joint Interconnection Facilities are owned in undivided interests of three-quarters by Generator and one-quarter by Company B. The Interconnection Agreement provides that neither party would be deemed to transmit any electricity for the other party over its portion of the Joint Interconnection Facilities.

Also, to accommodate the additional capacity from GT1, GT2, GT3, and GT4, Company B made certain improvements to the System (System Improvements). The System Improvements are upgrades that would not have been required but for the interconnection of the four generators. To accommodate GT1, GT2, and GT3, Company B (i) constructed two breakers at Substation A and two breakers at Substation C and (ii) retired certain equipment at those substations. To accommodate GT4, Company B (i) constructed 132-41 disconnect switches, a 132-71 wave trap, and 132-71 disconnect switches at Substation D and Substation E and (ii) retired certain equipment at those substations.

The Interconnection Agreement provides that the cost of the System Improvements incurred during the first phase with respect to GT1, GT2, and GT3 would be borne one-third by Company B and two-thirds by Generator. The cost of the System Improvements incurred during the second phase with respect to GT4 would be borne 100 percent by Generator. (The System Improvements with respect to GT2, GT3, and GT4 are referred to as the Generator Improvements and the cost thereof as the Generator Reimbursement.) The System Improvements, including the Generator Improvements, became part of the System and Company B has full ownership of them. The Interconnection Agreement provides that, in addition to the Generator Reimbursement, Generator would pay an amount equal to the estimated federal and state income taxes attributable to Company B treating the Generator Reimbursement as gross income.

The System Improvements with respect to GT4, and the resulting Generator Reimbursement are the focus of this ruling request (Intertie).

The Interconnection Agreement terminates, absent default, on the earlier of (i) Date 6 or (ii) the termination, for any reason, of the Site Lease and Easement Agreement between Company B and Generator, dated Date 4. The Lease Agreement was amended, as of Date 7, to accommodate GT4. As amended, the term of the Lease Agreement is from Date 4 through Date 8.

All of the relevant facilities were constructed as envisioned by the Interconnection Agreement. Company B made the System Improvements and constructed the Subsidiary Interconnection Facilities and the Joint Interconnection Facilities.

The Generator Improvements for GT4 were made in Year 1 and Year 2, and GT4 began commercial operation on Date 3. Generator anticipates making the Generator Reimbursement with respect to the Generator Improvements for GT4 during Year 3. Company B and Generator estimate that the cost of that reimbursement will be approximately $b. Generator will owe a tax gross-up of approximately $c if Company B is required to include the Generator Reimbursement with respect to GT4 in gross income.

Because of the limited operating schedule for the Facility, Generator and Company B entered into an Operations and Maintenance Agreement, dated as of Date 9, under which Company B provides contract labor to operate and maintain the Facility on behalf of Generator. The Operations and Maintenance Agreement was entered into between the parties d months after the Interconnection Agreement and is unrelated to the deemed contribution from Generator to Company B for the System Improvements necessary for Generator to sell the electricity generated at the Facility. Thus, the reimbursement from the System Improvements is not made to Company B with respect to the services provided to Generator by Company B under the Operations and Maintenance Agreement.

Generator uses the Intertie to effect the sale of power generated by the Facility to third parties, including Company B. Generator and Company D entered into an agreement for the sale of electricity to Company D. The agreement dated Date 10, provides for the sale of all of the electricity produced by GT2 and GT3 to Company D through Date 11. Under this agreement, Company D provides gas to Generator and Generator sells electricity to Company D. Generator takes title to, and assumes the risk of loss of, the gas provided by Company D at the gas metering equipment at the interconnection between the interstate gas pipeline and local pipeline installed by Company E. Company D takes title to the electricity at the meters on the high side of the transformers owned by Generator. The arrangement between Generator and Company D is characterized by the Federal Energy Regulatory Commission as a sale of electricity for federal regulatory and tariff purposes.

As described above, title for all electricity sold by Generator passes to the purchaser at the meters on the high side of the transformers owned by Generator.

Electricity travels from those meters to the busbar and from the busbar to the System. Thus, title to electricity sold by Generator passes to the customer prior to the busbar and entry of the electricity into the System.

Taxpayer makes the following additional representations: (1) the Intertie is a dual-use intertie as it may be used to transmit power from Company B or third parties to the Facility. However, the parties expect that the amount of power flowing back over the Intertie to the Facility will not exceed five percent of the projected total power flows over the Intertie during the first ten taxable years, beginning with the year in which the Intertie was placed in service; (2) Company B has not and will not include any amount attributable to the Intertie in its rate base; (3) if the Service grants the requested ruling, Company B will take no basis in the Intertie and, therefore, will not take any related depreciation or amortization deductions with respect to the Intertie; and (4) if the Service grants the requested ruling, Generator will capitalize the cost of the Intertie as an intangible asset recovered using the straight-line method over a useful life of 20 years.

Taxpayer further represents that the transfer of the Intertie by Generator to Company B possesses the characteristics described below. First, the Intertie has become a permanent part of the System. Second, the transfer is not compensation for services provided for Generator by Company B. In particular, the Generator Reimbursement is not payment for the services Company B provides Generator under the Operations and Maintenance Agreement, which was the result of arm's length negotiations and which provides for compensation at fair market rates. Third, the transfer is a bargained-for-exchange because Company B and Generator entered into the necessary agreements willingly and at arm's length. Fourth, the transfer will foreseeably result in a benefit to Company B commensurate with its value because the Intertie has become a part of the System. Fifth, the Intertie is used by Company B in its trade or business for producing gross income.

RULING REQUESTED

Taxpayer requests the Service to rule that the transfer by Generator to Company B of the Intertie 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, 2001-2 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 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 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 Company B have entered into a long-term interconnection agreement with an initial term of more than e years; (3) the Intertie will be used in connection with the transmission of electricity for sale to Company B or third parties (wheeling); (4) the cost of the Intertie will not be included in Company B's rate base; (5) the Intertie is a dual-use intertie; however, based on all available information, during the ten taxable years beginning with the year in which the Intertie was placed in service, no more than five percent of the total power flows over the Intertie will flow to Generator; (6) ownership of the electricity sold will not be with Generator prior to its transmission on the System; 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 contribution of the Intertie by Generator to Company B 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 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 proposed transfer of the Intertie by Generator to Company B possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the Intertie has become a permanent part of the System. Second, the transfer is not compensation for services provided for Generator by Company B. In particular, the General Reimbursement is not payment for the services Company B provides Generator under the Operations and Maintenance Agreement, which was the result of arm's length negotiations and which provides for compensation at fair market rates. Third, the transfer is a bargained-for-exchange because Company B and Generator entered into the necessary agreements willingly and at arm's length. Fourth, the transfer will foreseeably result in a benefit to Company B commensurate with its value because the Intertie has become a part of the System. Fifth, the Intertie is used by Company B in its trade or business for producing gross income. Therefore, Company B's receipt from Generator of the Intertie 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 Intertie by Generator to Company B 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 Taxpayer's representation that less than five percent of the total projected power flows over the Intertie from Company B to Generator is a reasonable projection for purposes of the five-percent test in Notice 88-129.

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,

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