Internal Revenue Service

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LEGEND

Taxpayer =

Parent =

State X =

County =

Developer A =

Developer B =

Developer C =

Developer D =

Developer E =

Year 1 =

Year 2 =

Date 1 =

Area 1 =

Area 2 =

Corridor 1 =

Corridor 2 =

a =

Dear :

This letter responds to your letter dated May 8, 2002, requesting a letter ruling on behalf of Taxpayer concerning whether the payments received by Taxpayer for the undergrounding of existing overhead electric distribution lines are nonshareholder contributions 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 wholly-owned subsidiary of Parent and a member of the Parent affiliated group. Parent is a holding company. Taxpayer is a regulated public utility under § 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 Parent affiliated group file a consolidated federal income tax return on a calendar year basis using the accrual method of accounting.

Taxpayer owns, operates, and maintains the electric distribution system. Some of its service areas are designated as underground service and others are overhead service. Where adequate overhead service is provided, a customer at its own expense may request the undergrounding of the existing service.

Developers A, B, C, D, and E (Developers), located in County, requested that Taxpayer undergound the overhead lines on their respective properties. Taxpayer was serving these locations from existing overhead lines. As a condition for obtaining the electrical construction services, Taxpayer required that Developers pay a contribution in aid of construction (CIAC) including a gross-up for the tax effect recovery factor before construction begins. Taxpayer recognized these payments as taxable income in the year of receipt. Payments were received starting in Year 1 and extending to Year 2. The estimated cost of relocating and undergrounding the overhead electrical facilities is approximately $a.

The Developers' projects are similar in nature: (1) at the time of the site plan review of the properties, Taxpayer provided service capacity by overhead distribution lines sufficient to serve Developers' properties; (2) the lines that served the properties also served other properties; (3) the undergrounding of the lines was not a prerequisite to new service because there already was service to the properties;(4) generally, several blocks of property would be combined to form a larger development, resulting in the removal of existing overhead distribution lines and replacing them with underground lines to the new facilities being constructed; and (5) County ordinance requires that

distribution lines along the perimeter of the property be undergrounder whenever construction takes place.

For Developers' properties, the undergrounding was done in accordance with County's Underground Utility Plan (Plan) which was adopted on Date 1. The Plan clearly demonstrates that the undergrounding was compelled by a specific public benefit which County required private developers to provide. County had clearly established plans for undergrounding in Area 1 and Area 2. The Plan was a capital improvement plan sponsored by County for the benefit of the public at large. In the Plan, Corridor 1, situated as it is within Corridor 2, is designated as the highest priority Underground Utility Development Area (UUDA). Although Developer C is not within Corridor 1, it did fall within the Plan due to its proximity to a designated Gateway. The Corridor plan is in addition to the basic site plan requirement for undergrounding.

The Plan estimates the length of overhead lines to be undergrounded and the costs within the designated UUDAs and in Gateway areas, of which Area 2 is one. This includes a specific estimate of linear feet to be undergrounded in Area 1, in which Developers' A, B, D, and E projects are located. The Capital Funding Strategies portion of the Plan recognizes that private sector contributions are expected in order to reduce an otherwise public responsibility. Consequently, the undergrounding was done pursuant to official County policy, which states that the "preferred placement of electric, telephone, and other utility lines would be underground. When this is not feasible, aerial lines should be placed along rear lot lines or similar areas which have low visibility." In the site plan review process, developers are required to underground the power lines in accordance with this policy and plan.

Taxpayer also represents that: (1) the underground lines have become a permanent part of Taxpayer's working capital structure; (2) the payments to Taxpayer are not compensation for services provided to Developers because, after the payments were made, Taxpayer was not required to provide services which were not already being provided by the overhead power lines; (3) the payments were bargained for because they were part of the consideration for construction of the project, and the parties negotiated for allocation of work responsibility and in other respects bargained for pricing and labor; (4) the payments will result in a benefit to Taxpayer commensurate with their value because they will be used as part of Taxpayer's electrical distribution system over which it provides electricity for sale to its customers; and (5) the underground lines will continue to be used by Taxpayer and its business to produce income.

RULING REQUESTED

Taxpayer requests the Internal Revenue Service to rule that the payments received by Taxpayer from Developers for undergrounding the existing overhead electric distribution lines are nonshareholder contributions to capital under § 118(a) and are not taxable CIACs under § 118(b).

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 taxpayer" does not include any CIAC or any other contribution as a customer or potential customer.

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, 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 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 Taxpayer, are includable in the gross income of the receiving corporation. The House Ways and Means Committee Report (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 is 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. H.R. Rep. No. 426, 99th Cong., 1st Sess. 644-45 (1985), 1986-3 (Vol. 2) C.B. 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.

In Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), 1950-1 C.B. 38, 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. 339 U.S. at 591, 1950-1 C.B. at 41.

In United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 413 (1973), the Court articulated five characteristics of a nonshareholder contribution to capital. 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.

In the present case, the undergrounding of the overhead lines on Developers' properties was a condition of site plan approval imposed by County under the Plan. Further, the undergrounding is mandated by County ordinance and undertaken for purposes of community aesthetics and for the general benefit of the public. Accordingly, we conclude that the payments to Taxpayer from Developers for the undergrounding of the overhead lines will not be treated as a CIAC under § 118(b). Furthermore, the payments to Taxpayer from Developers meet the five characteristics of nonshareholder contributions to capital stated in United States v. Chicago, Burlington & Quincy Railroad Co.

Based solely on the foregoing analysis and the representations made by Taxpayer, we rule as follows:

The payments received by Taxpayer from Developers for undergrounding the existing overhead electric distribution lines are nonshareholder contributions to the capital of Taxpayer under § 118(a) and are not CIACs under § 118(b).

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

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Enclosure: 6110 copy