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Department of the Treasury

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Date:
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LEGEND

Taxpayer =

Corp 1 =

Corp 2 =

Corp 3 =

Generator =

Power Marketer =

State A =

State B =

State C =

Location A =

Facility =

Substation =

b =

c =

d =

e =

f =

g =

h =

k =

m =

n =

o =

p =

Dear :

This letter responds to your letter dated December 3, 2002, submitted on behalf of Taxpayer, requesting a letter ruling concerning whether the payments made by Generator to Corp 3, which, in turn, reimbursed Taxpayer for the cost of a high-voltage electric interconnection, will be excluded from Taxpayer's gross income as a contribution to the capital of Taxpayer under § 118(a) of the Internal Revenue Code, and will not be treated as a contribution in aid of construction to Taxpayer under § 118(b).

Taxpayer represents that the facts are as follows.

Taxpayer is a regulated public utility, organized under the laws of State A and State B. Taxpayer provides power transmission and distribution services to independent power producers and other stand-alone power generators (collectively, "SAGs"). Taxpayer is a wholly-owned subsidiary of Corp 2, a State A corporation. Corp 2 is a wholly-owned subsidiary of Corp 1. Taxpayer is a member of the consolidated group for federal income tax purposes, of which Corp 1 is the common parent.

Generator is a SAG located in State 1. The Generator power generation facility (the "Facility") is located in Taxpayer's service area at Location A, which includes State A, State B and State C. Pursuant to FERC Order No. 888, regulated public utilities such as Taxpayer must allow SAGs to interconnect to the transmission grid so that generators can sell or "wheel" power over the transmission grid for delivery to customers or other intermediaries (collectively, "Customers"). Similar to most other regulated public utilities, Taxpayer required Generator to pay the design, engineering and construction costs for all transmission lines, substations, modifications and network system upgrades (collectively, the "Interconnection") necessary to interconnect the

Facility to Taxpayer's transmission grid. Taxpayer designed, engineered, constructed and owned the Interconnection and was reimbursed for all related costs by Generator. Consequently, Taxpayer and Generator each entered into certain agreements that allowed the Facility access to Taxpayer's transmission grid for the purpose of selling its power to Customers in the wholesale power market.

The Facility commenced commercial operation on b, and physically interconnected to Taxpayer's transmission grid at that time. Prior to commercial operations, Generator entered into a tolling agreement with Power Marketer, whereby Power Marketer agreed to supply natural gas to the Facility and Generator agreed to deliver the resulting electricity to Power Marketer. Generator does not store any natural gas at the Facility and legal title to the natural gas remains with Power Marketer. Further, Generator never has legal title to the electricity produced by the Facility. Power Marketer owns the electricity and sells or wheels the electricity to Customers in the wholesale power market. Title to the electricity passes to Customers prior to the transmission of the electricity on Taxpayer's transmission grid. Specifically, title to the electricity owned by Power Marketer passes to Customers at the meter located at the high side of the step-up transformer on the Facility side of the point of Interconnection.

Additionally, the Facility interconnects to Taxpayer's transmission grid through a one-way Interconnection that allows electricity to flow only in the direction of the transmission grid, not in the direction of the Facility. Thus, the transfer of the Interconnection to Taxpayer was made exclusively in connection with the sale of power to Customers in the wholesale power market.

Corp 3 and Generator initially entered into an interconnection services agreement on h (the "ISA"), whereby Generator was granted interconnection service under the Corp 3 Open Access Transmission Tariff. Corp 3 is the independent system operator that manages the reliability of the bulk power transmission system and facilitates the competitive wholesale power market in the service area in which the Facility operates. Corp 3 coordinates the planning of all interconnected power generation to the transmission system located in the Corp 3 service area, manages the wholesale power market for the Corp 3 service area, and provides accounting and billing services for all related transactions.

In Taxpayer's case, Corp 3 was the independent "middle-man" that approved the interconnection of the Facility to Taxpayer's transmission grid and coordinated the construction of and payment for the Interconnection. For example, Corp 3 periodically billed Generator for the accrued construction costs of the Interconnection and subsequently remitted the payments to Taxpayer. Pursuant to the ISA, Generator also agreed to provide a letter of credit to Corp 3 in the amount of $c, naming Corp 3 and Taxpayer as beneficiaries, to secure the estimated costs of construction for the Taxpayer-owned Interconnection. In summary, Taxpayer was responsible for the construction and ownership of the Interconnection and was reimbursed for the costs of construction by Corp 3 after Corp 3 billed and received payment from Generator.

On k, Taxpayer and Generator entered into the Interconnection Agreement (the "IA"), whereby Taxpayer and Generator agreed to interconnect the Facility to the Taxpayer's transmission system. Specifically, Taxpayer agreed to interconnect the Facility to Taxpayer's transmission grid in order to enable the transfer of energy and ancillary services produced by the Facility from the Point of Interconnection directly to the transmission grid. The Facility initially consisted of m gas-fired, d megawatt simple-cycle combustion turbine generators used in the production of electricity. Generator planned to add an additional e megawatt steam turbine generating unit at some future date to increase the total generating capacity of the Facility to f megawatts.

The Facility interconnected to Taxpayer's transmission grid at the Point of Interconnection. The Point of Interconnection was at the disconnect switch, which is the point in the high-voltage power line where the Taxpayer could "flip a switch" to either connect or disconnect the Facility from Taxpayer's Substation and transmission grid. Everything on Taxpayer's side of the Point of Interconnection was owned by Taxpayer and considered a part of the transmission grid. Title to the electricity produced by the Facility and wheeled to Customers was owned by Power Marketer and passed to the Customers prior to the Point of Interconnection and, consequently, prior to the transmission of the electricity on the Taxpayer's transmission grid. Generator never owned title to the electricity.

Certain construction was necessary in order to connect the Facility to the transmission grid at the Substation. For example, Taxpayer had to replace or upgrade certain high voltage equipment that included, at the Substation, a g kV substation ring bus strain conductor and certain g kV group operated disconnect switches, as well as the upgrade of incoming terminal position bus and metering instrument transformers. The construction of the Interconnection and the resulting payments for costs of construction, pursuant to the IA and the ISA, occurred prior to the initial sale of power by the Facility to the Customers.

The IA will remain in full force and effect from unless it is terminated pursuant to the provisions of Article p of the IA. Taxpayer did not include the costs of the Interconnection in the regulatory rate base upon which its rates are determined under standard cost-based rate regulation. Generator capitalized the cost of the Interconnection as an intangible asset, recovering costs using the straight-line method of depreciation over a useful life of twenty years.

Taxpayer requests a ruling that the payments made by Generator to Corp 3 that, in turn, reimbursed Taxpayer for the costs of design, engineering and construction of the Interconnection will not be a contribution in aid of construction to Taxpayer under § 118(b) and will be excluded from Taxpayer's gross income as a contribution to capital under § 118(a).

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 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 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). 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 interconnection equipment (intertie) by a Qualifying Facility. 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.

The notice 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 Interconnection is subject to the guidance set forth in Notice 88-129, Notice 90-60, and Notice 2001-82 for the following reasons: (1) the Project 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 Interconnection will be used in connection with the transmission of electricity for sale to third parties; (4) the cost of the Interconnection will not be included in Taxpayer's rate base; (5) no amount of power will flow back over the Interconnection to Generator; (6) ownership of the electricity wheeled will not be with Generator prior to its transmission on the grid; and (7) the cost of the Interconnection 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 transfer of the Interconnection 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 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 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), 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. Id. at 41.

Finally, in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 413 (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.

Based on the facts presented, we conclude that the transfer of the Interconnection by Generator to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. Therefore, the transfer of the Interconnection by Generator to Taxpayer 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 Interconnection by Generator to Taxpayer will not constitute 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 on whether the agreement between Generator and Power Marketer is a sales contract or a service agreement.

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.

In accordance with the power of attorney on file, copies of this letter are being sent to Taxpayer and the second authorized legal representative listed.

Sincerely,

Walter Woo
Senior Technician Reviewer, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy