Internal Revenue Service

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Department of the Treasury

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CC:PSI:5 — PLR-112262-02
Date:
June 3, 2002

LEGEND

Taxpayer =

Generator =

Company =

Power Marketer =

State A =

State B =

Grid A =

Grid B =

<u>b</u> =

<u>c</u> =

<u>d</u> =

<u>e</u> =

<u>f</u> =

<u>g</u> =

<u>h</u> =

Dear :

This letter responds to your authorized representative's letter dated February 22, 2002, and subsequent correspondence, submitted on behalf of Taxpayer, requesting a letter ruling concerning whether the transfer of an intertie from Generator to Taxpayer is a 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 an electricity generation and transmission cooperative engaged in generating, transmitting and selling electric power in State A and surrounding states. Taxpayer has expertise in the planning, construction, and maintenance of power lines in State A. In addition, Taxpayer possesses the power of eminent domain in State A, and hence can condemn necessary property and obtain the easements necessary to build power lines in State A using that authority and its construction management expertise.

Taxpayer entered into negotiations with Generator, an affiliate of Company, an energy services company, to build, own, maintain, and operate a b-mile electric interconnect transmission line (Intertie) from Generator's electricity manufacturing plant (Plant) being constructed in State A to a transmission line owned by Generator in State B. The Plant in State A will manufacture electricity to be consumed in State A and other states (via an interconnection to Grid A near the Plant) and in State B (by utilization of the Intertie).

Generator has entered into an agreement with Power Marketer, whereby Power Marketer will supply natural gas to the Plant, and Generator will deliver electricity to Power Marketer at both Grid A and Grid B. The only interconnection involving Taxpayer is the Grid B interconnection involving the Intertie, which will connect the Plant with a c-mile Generator transmission line in State B which in turn will intertie into Grid B. Power Marketer will then market the power transmitted by Taxpayer over Grid B.

The agreement between Power Marketer and Generator provides that Generator will manufacture electricity for Power Marketer over a d-year term with an e-year extension period at either party's option. Generator will take natural gas provided by Power Marketer and manufacture it into electricity. Generator will not store any natural gas at the Plant. Legal title to the natural gas will pass from Power Marketer to Generator at the entrance to the Plant and risks of loss within the Plant and inefficiency will rest with Generator. Generator estimates that 100 percent of its Plant capacity will be utilized for the manufacturing agreement with Power Marketer. As to the electricity transmitted on the Intertie, legal title to the electricity will pass from Generator to Power Marketer only at Generator's c-mile line interconnection with Grid B pursuant to the agreement between Generator and Power Marketer.

Under the agreements between Generator and Taxpayer, Generator will fund Taxpayer's construction of the Intertie, including Taxpayer's costs to obtain related easements and permits. These costs are estimated to be approximately $f (the $g incentive amount for completion of the project for a time certain is excluded from this amount). Taxpayer will own the Intertie and will provide Generator with noninterruptible service, pursuant to a long-term interconnection agreement and facilities agreement, over the Intertie to transmit the entire capacity of the Plant for h years, subject to extension options.

The terms of the contemplated agreements between Generator and Taxpayer provide that ownership of the electricity transmitted by Generator over the Intertie will remain with Generator throughout its transmission over the Intertie. Taxpayer will have the right to utilize for its own account any line capacity of the Intertie that Generator does not occupy, should any exist. Taxpayer believes that under the present circumstances, it is unlikely that any excess capacity will exist, or if it exists, that will benefit Taxpayer since the electricity manufactured by Generator for transmission by Taxpayer will be non-synchronous with the rest of Taxpayer's transmission system. The electricity that is manufactured by Generator will not enter Taxpayer's transmission system other than to travel along the Intertie. The Intertie will not connect to any existing power lines of Taxpayer.

Generator will not pay any transmission fees to Taxpayer. Rather, Taxpayer will receive only allowable maintenance fees from Generator during the course of the interconnection agreement. Further, while there is no explicit transmission fee paid by Power Marketer to Generator, the pricing of the delivered electricity under their arrangement by virtue of the requirement that Generator deliver the electricity to Grid B, subsumes some compensation to Generator for that delivery. From that point, Power Marketer has a transmission agreement with Grid B and pays a transmission fee at that point.

The costs of the construction of the Intertie will not be depreciated for tax purposes by Taxpayer. Further, Taxpayer will not amortize the Intertie and the value of the Intertie will not be recovered from or affect the price of power it provides to its customers and members.

Taxpayer further represents that the characteristics described below are present with respect to the contemplated transfer of the Intertie by Generator to Taxpayer. First, the Intertie will become a permanent part of Taxpayer's capital structure because the Intertie will be owned by Taxpayer. Second, Generator's contribution is not compensation for services from Taxpayer because Generator is not a customer of Taxpayer. Third, the payment for the construction of the Intertie is bargained for because the interconnection agreement contains substantial conditions that Taxpayer and Generator negotiated to further and protect their separate business interests. Fourth, contribution benefits Taxpayer because it provides an asset by which a new market for electricity may become available to Taxpayer to the extent Generator may not utilize the Intertie's full capacity. Taxpayer will also benefit from earning annual maintenance fees for the years the Intertie is in service. Fifth, the Intertie is expected to generate additional income for Taxpayer through future transmission fees and maintenance fees.

Generator represents that the costs advanced to Taxpayer by Generator will be capitalized by Generator as an intangible asset and recovered using a straight line method over a useful life of 20 years.

RULING REQUESTED

Taxpayer requests the Service to rule that the transfer of the Intertie by Generator to Taxpayer will not be contribution in aid of construction under § 118(b), and will be 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 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 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 Plant is a stand-alone generator as contemplated under Notice 2001-82; (2) Generator and Taxpayer have entered into a long-term interconnection agreement with an initial term of h years; (3) the Intertie will be used in connection with the transmission of electricity for sale to third parties (wheeling); (4) the cost of the Intertie will not be included in Taxpayer's rate base; (5) the Intertie is not a dual-use intertie; (6) ownership of the electricity wheeled will not be with Generator prior to its transmission on Grid B; 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 transfer of the Intertie 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.

The proposed transfer of the Intertie by Generator to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the Intertie will become a permanent part of Taxpayer's working capital structure because Taxpayer will own the Intertie. Second, the Generator's contribution is not compensation for services, including transmission services, provided to Generator by Taxpayer. Third, in the proposed transaction, the contribution of the Intertie is bargained for because the interconnection agreement contains substantial conditions that Generator and Taxpayer negotiated to further and protect their separate business interests. Fourth, the contribution benefits Taxpayer because it provides an asset by which a new market for electricity may become available to Taxpayer to the extent Generator may not utilize the Intertie's full capacity. Taxpayer will also benefit from the proposed transaction through earning annual maintenance fees for the years the Intertie is in service. Fifth, the Intertie is expected to generate additional income for Taxpayer through maintenance fees, and possible future transmission fees to the extent Generator may not utilize the Intertie's full capacity. Therefore, Taxpayer'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 Taxpayer 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 on whether the agreement between Generator and Power Marketer is a sales contract or a service agreement.

In accordance with the power of attorney filed with this request, we are sending copies of this letter ruling to your first and second authorized representatives.

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

Enclosure: 6110 copy