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Department of the Treasury

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CC:PSI:5 — PLR-152099-02
Date:
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LEGEND

Taxpayer A =

Taxpayer B =

Utility A =

Utility B =

Generator =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

State =

City =

Company A =

Company B =

Company C =

Company D =

Company E =

Company F =

Organization =

b =

c =

d =

e =

f =

g =

h =

i =

j =

Dear :

This letter responds to Taxpayer A's and Taxpayer B's (Taxpayers) letter dated September 20, 2002, and subsequent correspondence, requesting a letter ruling concerning whether the transfer of an intertie by Generator to Utility A is a nonshareholder contribution to capital excludable from Taxpayer A's income under § 118(a) of the Internal Revenue Code.

Taxpayers represent that the facts are as follows:

FACTS

Taxpayer A is an energy company that owns electricity transmission and distribution assets, among other things. Taxpayer A is a calendar year taxpayer and uses the accrual method of accounting. Effective Date 1, Utility A and Company A joined together to create Taxpayer A.

Utility A is a corporation organized under the laws of State. Utility A owns and operates an electric power transmission and distribution system. Utility A is a calendar year taxpayer and uses the accrual method of accounting.

Taxpayer B is a provider of electricity-related services. Taxpayer B owns Generator through its various subsidiaries. Taxpayer B owns b percent of Company B, which owns b percent of Company C, which owns b percent of Company D. Company D owns Company E and Company F. Company E and Company F own c percent and d percent of Generator, respectively, in a limited partnership. Company E is the limited partner and Company F is the general partner. For federal income tax purposes, all of the aforementioned entities in the chain of ownership below Company B are disregarded under § 301.7701-3 of the Procedure and Administration Regulations.

Generator is constructing a power generating station (Facility) located in City. Generator anticipates that the Facility will be operational by Date 2. To sell power to its customers, the Facility must interconnect with the grid. In the area in which the Facility is located, the grid is owned by Utility A. The additional power generated by the Facility will necessitate system upgrades on Utility A's portion of the grid, as well as portions of the grid owned by Utility B. The new connecting and transmission facilities and the necessary system upgrades on Utility A's portion of the grid form the "intertie" (Intertie) that is the focus of this letter ruling.

Organization is the regional transmission organization that manages the high voltage transmission grid at the point at which the Facility interconnects. Organization operates a wholesale electric market. Organization is responsible for providing safe and reliable operation of the high voltage electric transmission system to assure the reliable supply of energy from generators to wholesale customers.

Several agreements govern Generator's interconnection to the grid. Pursuant to the tariff on file with the Federal Energy Regulatory Commission (FERC), Generator and Organization entered into an Interconnection Services Agreement (ISA), which governs the conditions of interconnection. The ISA sets forth project milestones and technical requirements. The ISA also requires Generator to abide by the rules and procedures pertaining to generation in Organization's control area and to comply with the terms of the open access tariff on file with the FERC. The ISA requires Generator to bear the costs of interconnecting the Facility to the grid and all required network upgrades. The FERC accepted the ISA on Date 3.

Utility A and Generator also have entered into an Interconnection Agreement (IA). Like the ISA, the IA also provides terms of connecting Generator to the grid, sets forth project milestones, and provides for termination rights. The IA also defines the continuing responsibilities and obligations of the parties with respect to the interconnection. Utility A agrees to interconnect with the Facility. Generator agrees that the Facility will not exceed a specified maximum output. Acceptance by the FERC of the ISA and the execution of construction agreements are conditions precedent to the IA becoming effective.

The term of the IA is e years or such longer period as mutually agreed upon by the parties. The agreement may be terminated at any time by mutual consent. Either party may terminate the agreement upon the permanent closure of the Facility, default, or failure of Generator to commence operations within f years of the effective date of the IA. Generator also has the right to terminate upon g days notice provided that Generator has satisfied Organization requirements and has obtained any required regulatory approvals. The FERC approval is required for termination. Upon termination, Generator is required to physically disconnect the Facility from the grid.

Utility A and Generator also have entered into two construction agreements under which Utility A and Generator are responsible for constructing various parts of the Intertie. The Construction Agreement for Attachment Facilities (CAAF) governs the construction of the switchyard and transmission modifications to connect the switchyard to the grid. Generator is constructing the switchyard and turning over the switchyard facilities to Utility A. Utility A is constructing the transmission modifications to connect the switchyard to the grid. A second agreement, the Construction Agreement for Network Upgrades (CANU), governs the construction of network upgrades within Utility A’s portion of the grid. Utility A is constructing all facilities governed by the CANU.

Generator is liable for all costs related to the Intertie. The construction agreements provide that Generator will prepay any Utility A costs of constructing the Intertie, including its share of network upgrades pursuant to the ISA and CANU, respectively. The ISA provides that all payments and billing activity flow through Organization. The ISA also governs network upgrades (including billing and payments) to the portions of the grid owned by Utility B. Organization has allocated the cost responsibility of the network upgrades to Generator and several other generators. If Organization increases or decreases Generator’s share of the costs, Generator or the grid owner, as the case may be, would be responsible for remitting or refunding any difference. When construction is complete, there will be a final accounting and Generator will pay the amount not already covered by its contributions or, alternatively, Utility A or Utility B will refund any overpayment. Generator will not take title to the portion of the Intertie that Utility A constructs. Rather, Utility A owns the portion of the Intertie that Utility A constructs throughout construction. Generator does have title to the switchyard during construction and turns title over to Utility A after satisfactory acceptance testing and energizing.

The construction agreements, the CAAF and CANU, become effective on the later of their execution dates and the dates on which certain conditions precedent are satisfied. The conditions include the Facility's execution of an interconnection service agreement with Organization. The construction agreements automatically terminate upon the satisfaction of the project milestones. They also may be terminated by mutual consent or by either party if Generator has abandoned the construction of the Facility, default by the other party, or Generator has not completed the Facility and/or the facilities it is required to build within f years. Finally, Generator may cancel the agreement upon g days written notice to Utility A. Construction began on the attachment facilities and network upgrades in Date 4 and completion is anticipated on Date 5.

The estimated cost of the Intertie will be approximately $h. This includes $i for the attachment facilities and $j for the network upgrades. These figures are good faith estimates and are subject to change.

The attachment facilities connecting the Facility to the grid are dual use. That is, power may flow from the grid to the Facility. This reverse power flow might occur during the initial start-up of the Facility or while the Facility is in a "stand-by" mode and otherwise only if the Facility loses power in an emergency. This latter circumstance is expected to occur rarely if at all. Generator does not anticipate that more than five percent of the total power flows over the first ten years the Facility is operational will be from the grid to the Facility.

Taxpayer makes the following additional representations: if the Service grants the requested rulings, (1) Utility A will exclude the Intertie from rate base and will not otherwise seek to recover the cost of the Intertie from ratepayers; (2) Utility A will not claim a tax basis in the Intertie; and (3) 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.

Also, Taxpayer A represents that ownership of the electricity produced by the Facility will transfer to the purchaser prior to entering the grid, and the Facility's customers will pay for transmission services.

Taxpayer further represents that the transfer of the Intertie by Generator to Utility A possesses the characteristics described below. First, the Intertie will become a permanent part of Utility A's working capital structure. Second, the transfer is not compensation for services provided for Generator by Utility A. Third, the transfer is a bargained-for-exchange because the agreements between Utility A and Generator contain meaningful conditions that Utility A negotiated on its own behalf. Fourth, the transfer will foreseeably result in a benefit to Utility A commensurate with its value because the Intertie will become a part of Utility A's transmission system. In particular, the Intertie will make a new source of electricity available to consumers and those consumers use Utility A's transmission system as a means of receiving delivery of that electricity. In addition, Utility A benefits by acquiring more efficient and higher capacity transmission lines and equipment. Fifth, the Intertie will be used by Utility A to generate additional income. The Intertie can be expected to generate additional income for Utility A to the extent purchasers pay transmission fees to Utility A for the electricity that the Intertie transports.

RULINGS REQUESTED

1. Taxpayer A requests on behalf of its subsidiary Utility A that the Service rule that the transfer by Generator to Utility A 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).

2. Taxpayer B requests on behalf of its subsidiary Company B as indirect owner of Generator, a disregarded entity, that Company B is entitled to recover the cost of the Intertie as provided under Notice 2001-82, 2001-2 C.B. 619.

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 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, 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 the Public Utilities Regulatory Policies Act (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. Conf. 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 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.

In the case of a dual-use intertie, Notice 88-129 provides that the contribution to a utility will be treated as a Qualifying Facility transfer (QF transfer) if, in light of all information available to the utility at the time of the transfer, it is reasonably projected that during the first ten taxable years of the utility, beginning with the year in which the transferred property is placed in service, no more than 5 percent of the projected total power flows over the intertie will flow to the Qualifying Facility (the "5% test").

Further, the notice provides, in part, that a transfer from a Qualifying Facility to a utility will not be treated as a 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 provides that the cost of property transferred must be capitalized by the generator as an intangible asset and recovered using the straight-line method over a useful life of 20 years.

Section 301.7701-2(a) provides that for purposes of §§ 301.7701-2 and 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. Moreover, § 301.7701-2(a) provides that a business entity with only one owner is classified as a corporation or is disregarded. If the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b) provides default classifications for an eligible entity that does not make an election. A domestic eligible entity with a single owner, unless it elects otherwise, is disregarded as an entity separate from its owner. Section 301.7701-3(b)(1)(ii).

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 Utility A have entered into a long-term interconnection agreement with a term of at least e years; (3) the Intertie will be used in connection with the transmission of electricity for sale to parties other than Utility A (wheeling); (4) the cost of the Intertie will not be included in Utility A's rate base, and Utility A will not otherwise seek to recover the cost of the Intertie from ratepayers; (5) Utility A will not claim a tax basis in the Intertie; (6) the Intertie will be a dual-use intertie; however, during the ten taxable years beginning with the year in which the Intertie is placed in service, Taxpayer A represents that no more than five percent of the total power flows over the Intertie will flow to Generator; (7) ownership of the electricity produced by the Facility will transfer to the purchaser prior to entering the grid, and the Facility's customers will pay for transmission services; and (8) 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 contribution of the Intertie by Generator to Utility A will meet 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 transfer will qualify 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 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 Utility A 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 Utility A's working capital structure. Second, the transfer will not be compensation for services provided for Generator by Utility A. Third, the transfer will be a bargained-for-exchange between Generator and Utility A. Fourth, the transfer will foreseeably result in a benefit to Utility A commensurate with its value because it will become part of Utility A's transmission system. Fifth, the Intertie will be used by Utility A in its trade or business for producing additional income. Therefore, Utility A'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 Taxpayers, we rule that the transfer of the Intertie by Generator to Utility A will not be a CIAC under § 118(b), and will be excludable from the gross income of Taxpayer A as a nonshareholder contribution to capital under § 118(a).

Further, Company B as indirect owner of Generator, a disregarded entity, will be entitled to recover the cost of the Intertie, which will be capitalized by Generator as an intangible asset, using the straight-line method over a useful life of 20 years.

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 A's representation that during the ten taxable years beginning with the year in which the Intertie is placed in service less than five percent of the total projected power flows over the Intertie from Utility A to Generator is a reasonable projection for purposes of the five-percent test in Notice 88-129. Also, no opinion is expressed or implied as to whether Generator or Companies C, D, E and F are disregarded entities as defined in § 301.7701-3(a).

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Harold E. Burghart

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Enclosure: 6110 copy