Internal Revenue Service

Number: **200324037**
Release Date: 6/13/200
Index No: 118.01-02
118.02-00

Department of the Treasury

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CC:PSI:5 — PLR-162144-02
Date:
MAR 04 2003

LEGEND

Taxpayer =

Facility =

Generator =

State A =

State B =

State C =

State D =

Commission =

Company A =

Company B =

Company C =

Intertie =

a =

Affiliate =

Year 1 =

Date 1 =

Dear :

This letter responds to Taxpayer's letter dated October 17, 2002, requesting a letter ruling concerning whether the loss of qualified facility (QF) status by Facility would give rise to a deemed transfer of an intertie by Generator to Taxpayer, and if so, if that transfer would be 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 is a public utility company organized and existing under the laws of State A. Taxpayer is engaged principally in the business of operating electrical transmission facilities in State A, State B, State C, and State D. Taxpayer is regulated by Commission. Taxpayer is an indirect, wholly owned subsidiary of Company A. Company A is the parent of a group of corporations which files a consolidated return. Taxpayer is included as a member of that consolidated federal income tax return.

Generator is a State A limited partnership. It is the owner and operator of Facility. Generator is a disregarded entity for federal income tax purposes and is treated as a division of Company B.

Currently, Facility is a QF as defined in section 3 of the Federal Power Act, as amended by section 201 of the Public Utilities Regulatory Policies Act of 1978 (PURPA). Facility, which has a nominal capacity of approximately aMW, began operation and was placed in service for federal income tax purposes in Year 1.

At the time Facility was placed in service, the Intertie was required to enable Generator to introduce electricity into Taxpayer's integrated transmission grid so that it could satisfy its supply obligation to Taxpayer under the long term power purchase agreement that was then in place. Taxpayer constructed the Intertie and Generator reimbursed Taxpayer for all costs. Upon completion of construction, Taxpayer transferred ownership of the Intertie to Affiliate.

Facility is currently classified as a merchant plant which means that it can sell the power it produces on the open market. In order to facilitate sales of its power output, Generator has entered into two separate agreements - an interconnection agreement (IA) and a power marketing agreement (PMA). Both agreements became effective on Date 1.

Generator entered into the PMA with Company C, a related entity. Under the PMA, Generator committed to sell all of its output to Company C.

Under PURPA, the facility is required to meet, *inter alia*, operating standards and efficiency standards both of which must be met to attain and retain QF status. The achievement of these standards places significant constraints on the operational flexibility available to Generator in its management of Facility. Upon review, Generator has determined that maintaining the operational characteristics necessary to the continuance of QF status is economically disadvantageous. Consequently, Generator intends to effect a forfeiture of its QF status. This will be accomplished by operating Facility in a fashion that will no longer meet the QF requirements.

RULING REQUESTED

Taxpayer requests the Service to rule that the change in the status of Facility from a QF under PURPA to a non-QF will not give rise to a taxable contribution in aid of construction (CIAC) within the meaning of § 118(b), and hence, Taxpayer will not realize any income relating to the change in Facility's QF status.

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, provide 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 QF to a utility is to permit the sale of power by the QF 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 QFs to utilities.

Notice 88-129 provides, in part, that with respect to transfers made by a QF to a utility exclusively in connection with the sale of electricity by the QF to the utility, a utility will not realize income upon transfer of an intertie by a QF. 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 QF 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 QF 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 QF 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 QF 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-QFs.

Nothing in any of the above cited authorities supports a conclusion that the change in QF status would give rise to a deemed contribution.

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer, we rule that the change in the status of Facility from a QF under PURPA to a non-QF will not give rise to a deemed transfer of an intertie by Generator to Taxpayer for purposes of § 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. Specifically, no opinion is expressed or implied as to whether Taxpayer met the requirements of Notice 88-129 when the Intertie was originally constructed and transferred in Year 1.

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,

/s/ Walter H. Woo

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

Enclosure: 6110 copy

cc