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118.02-00	**Person to Contact:**
	Telephone Number:
	Refer Reply To:
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	Date:
	MAY 07 2003

LEGEND

Taxpayer =

Generator =

State A =

State B =

State C =

State D =

State E =

State F =

Commission =

Division A =

Division B =

Division C =

Entity =

Member =

Company A =

Company B =

Company C =

Company D =

Company E =

Facility =

Substation A =

Substation B =

Substation C =

Substation D =

Substation E =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

a =

b =

c =

d =

e =

f =

g =

h =

Dear :

This letter responds to Taxpayer's letter dated December 20, 2002, requesting a letter ruling concerning whether the transfer of interconnection facilities to Taxpayer is 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 corporation organized under the laws of State A and is subject to regulation by Commission. Taxpayer is under the audit jurisdiction of Division A.

Generator, an Entity under the audit jurisdiction of Division B, is a not-for-profit power supply cooperative formed to provide wholesale electric services to its members on a cost effective basis. Generator's members include a customer-owned electric distribution cooperatives that sell electric services to retail customers in portions of State B, State C, and State D. Power is provided to the member distribution cooperatives pursuant to long-term, all-requirements wholesale power contracts, which obligate Generator to supply and the member distribution cooperatives to purchase, all of their capacity and energy requirements. Under the wholesale power contracts, Generator is responsible for transmitting energy to its member distribution cooperatives. Those transmission costs, along with all of Generator's cost of purchasing or generating power, are paid by the member distribution cooperatives under their respective wholesale power contracts.

Generator also sells power to Member. Member, which is not a distribution cooperative, was formed by the member distribution cooperatives, among other business reasons, to help reduce the member distribution cooperatives' power costs by selling to the open market any power generated by Generator that is in excess of the member distribution cooperatives' needs.

Company A is a State B limited liability company whose sole member is Generator. Company A is treated as a disregarded entity and as a division of Generator for federal income tax purposes. Generator created Company A to accommodate certain business and financing objectives during the development of

Facility. Generator currently anticipates that at some time during the next b months Company A will be liquidated and all of its interest in Facility will be transferred to Generator.

Company B, a State D corporation, is under the audit jurisdiction of Division C. Company B is a wholly owned subsidiary of Company C, which is engaged in the production and sale of energy. Company A and Company B are jointly developing Facility to produce electricity for resale. As an exempt wholesale generator, Company B will sell the energy generated by its interest in Facility exclusively into the wholesale electric market. Title to the energy produced by Company B's interest in Facility will pass at Facility's busbar to the purchaser of such energy.

As currently structured, Company A will be an exempt wholesale generator which will enter into a wholesale power purchase contract obligating it to sell all of its energy to Generator. Under this arrangement, title to the energy will pass to Generator at Facility's busbar.

Generator is participating in the construction of Facility principally to provide electric capacity and related energy to its member distribution cooperatives. However, there will be times when the energy produced by Generator's interest in Facility exceeds the energy required by the member distribution cooperatives and this excess will by sold to Member. Member will then sell that energy on the open market.

If Company A's interest in Facility is eventually transferred directly to Generator, then Generator will sell its interest in energy generated by Facility (which exceeds the member distribution cooperatives' needs) to Member. Title to the energy sold by Member will pass at Facility's busbar to the purchaser. Bare legal title to the energy sold by Generator to its member distribution cooperatives will pass at the respective distribution points, however, under the various wholesale power contracts, the member distribution cooperatives incur all the risks and costs of transmitting the energy produced at Facility. Based on the burdens and benefits of ownership, it is represented that ownership of the transmitted power will pass to the member distribution cooperatives prior to transmission on the grid.

The property where Facility is located currently has electric service and the system upgrades are not needed to provide electric service to Facility. It is anticipated that electricity provided to Facility will be from a combination of self-generation, Company D, and the Company E spot market. Facility will be generating for resale a far greater amount of energy than the amount of energy that it will be purchasing to run Facility. Projections indicate that during the first ten taxable years, the energy that Facility will receive from Company D and the Company E spot market will equal less than 2.5% of the total energy generated by Facility. In no event will Facility purchase energy from Taxpayer.

Energy generated by Facility must be transmitted to consumers over

transmission assets operated and owned by other public utilities. Under the Federal Energy Regulatory Commission (FERC) policy of open access, the owners of transmission assets must transmit energy pursuant to cost-based rates regardless of where it is produced or by whom it is purchased. Facility is located in an area served by a system of interrelated transmission assets known as the Company E Transmission Grid, which is operated and controlled by Company E. Company E is a regional transmission organization and an independent system operator subject to regulatory jurisdiction by FERC under the Federal Power Act. Company E is responsible for operation and control of the bulk electric power transmission system in all or portions of State A, State B, State C, State D, State E, and State F.

Transmission charges are generally paid to Company E by the purchaser of the energy (not the generator), for the transmission of purchased energy across the Company E Transmission Grid. The basis for these transmission charges are controlled by the Company E Open Access Transmission Tariff (OATT) filed with FERC. Under the OATT, transmission customers generally are charged a basic transmission rate (that allows Company E to reimburse transmission asset owners for their investment in transmission assets). The developers of new generating facilities, such as Facility, must bear all costs related to upgrades or new construction of transmission assets needed to interconnect the new generating facility to the Company E Transmission Grid.

The members of Company E are public utilities that own transmission assets that interconnect with each other to create the Company E Transmission Grid. Although Company E is responsible for operation and control of the Company E Transmission Grid and the provision of transmission services across the Company E Transmission Grid, the members of Company E still retain title to their transmission assets. Each member of Company E is compensated for the use of its transmission assets by Company E in accordance with a cost of service rate tariff filed with FERC. Additionally, title to all system upgrades remains with the public utility that owns the underlying transmission assets, not Company E, or the new generating facility that is paying for the system upgrades.

In accordance with the OATT and to evidence Company A and Company B (the Joint Owners) and Company E's respective rights and obligations under the OATT, the Joint Owners and Company E have entered into an interconnection service agreement (the ISA), dated Date 5, which authorizes the construction of facilities for the purpose of connecting Facility to the Company E Transmission Grid.

Taxpayer is a member of Company E and is one of the Company E transmission asset owners, with interconnected transmission and distribution facilities in southeastern State A, northeastern State C and elsewhere (the Taxpayer Transmission System). The ISA provides that, as a condition to interconnecting to the Company E Transmission Grid, the Joint Owners must pay for the system upgrades. Company E has determined that system upgrades must be made to the Taxpayer Transmission

System, among others, to accommodate the electric output of Facility. The Joint Owners executed an Interconnection Agreement (the IA) with Taxpayer effective Date 3 and filed with FERC on Date 6. Pursuant to Article 18 of the IA, it will remain in full force and effect from the date it is executed until or unless terminated.

In connection with the IA, the Joint Owners and Taxpayer have negotiated three construction agreements. The Joint Owners have appointed Generator as their construction agent. In its role as construction agent, Generator entered into the construction agreements. These agreements provide for the construction of new facilities or modifications to existing facilities within the Taxpayer Transmission System, which are necessary for Facility to interconnect with the Company E Transmission Grid.

The first construction agreement, dated Date 1, relates to the construction and modification of facilities at the portion of the Taxpayer Transmission System known as Substation A. This agreement provides for the replacement of c circuit breakers, as well as modification to d other circuit breakers. The initial estimate of costs for the portion of the construction and/or modifications made pursuant to this agreement was $e.

The second construction agreement, dated Date 2, also relates to facilities at Substation A. This agreement provides for line modifications to an existing right of way to provide for a connection for Facility to the Company E Transmission Grid. The initial estimate of costs for the modifications made pursuant to this agreement was $f.

The third construction agreement, the original of which was effective and filed with FERC on Date 4, has subsequently been amended. The amended version, as of yet, has not been filed with FERC. This agreement relates to the construction of facilities at Substation B, Substation C, Substation D, and Substation E. This agreement contemplates the replacement of a total of g circuit breakers at the substations. The estimate of costs for the construction performed pursuant to this agreement was $h.

The terms of the construction agreements are all substantially similar, except for provisions in the second agreement relating to certain facilities to be constructed and owned by the Joint Owners. Pursuant to the construction agreements, at the sole cost of the Joint Owners, Taxpayer is responsible for the design, purchase, construction, and installation of the various facilities. Taxpayer is also responsible for obtaining all permits, licenses or approvals necessary to construct, purchase, install, own, operate, and maintain the facilities. The costs and expenses associated with such permits, licenses, or approvals are to be paid by the Joint Owners.

Article 11 of each of the construction agreements provides that the Joint Owners shall be responsible for all costs, including any applicable tax gross-up, that Taxpayer actually incurs in performing its obligations under the construction agreements. Taxpayer is required to provide the Joint Owners with invoices (based on estimates of

anticipated costs), and the Joint Owners are required to prepay the estimated costs. The payments from the Joint Owners to Taxpayer are to be made quarterly, and are to correlate with the work to be performed by Taxpayer in the subsequent three months. Although the Joint Owners will pay all costs of construction and installation of the facilities, Taxpayer will hold the legal title to them. However, Taxpayer will not include the facilities (or costs) in its rate base in determining the rates charged for use of its transmission assets, including rates charged to Company E.

RULING REQUESTED

Taxpayer requests the Service to rule that the transfer by the Joint Owners to Taxpayer of the interconnection facilities 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).

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, 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 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 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.

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.

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 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 facilities is subject to the guidance set forth in Notice 88-129, Notice 90-60, and Notice 2001-82 for the following reasons: (1) Facility is a stand-alone generator as contemplated under Notice 2001-82; (2) the Joint Owners and Taxpayer have entered into a long-term interconnection agreement; (3) the interconnection facilities will be used in connection with the transmission of electricity for sale to the member distribution cooperatives, Member or third parties (wheeling); (4) the cost of the interconnection facilities will not be included in Taxpayer's rate base; (5) based on all available information, during the ten taxable years beginning with the year in which Facility is placed in service, no more than 2.5 percent of the total power flows over the interconnection facilities will flow to the Joint Owners; (6) ownership of the electricity wheeled passes to the purchaser prior to its transmission on the Company E Transmission Grid; and (7) the cost of the interconnection facilities will be capitalized by the Joint Owners as an intangible asset and recovered using the straight-line method over a useful life of 20 years. Thus, we conclude that the deemed contribution of the interconnection facilities by the Joint Owners 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 transfer 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 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 interconnection facilities by Generator and the Joint Owners to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the interconnection facilities will become a permanent part of the Taxpayer Transmission System. Second, the transfer is not compensation for services provided for the Joint Owners by Taxpayer. Third, the transfer is a bargained-for exchange because Taxpayer the Joint Owners entered into the necessary agreements willingly and at

arm's length. Fourth, the transfer will foreseeably result in a benefit to Taxpayer commensurate with its value because the interconnection facilities will become a part of the Taxpayer Transmission System. Fifth, the interconnection facilities will be used by Taxpayer in its trade or business for producing gross income. Therefore, Taxpayer's receipt from the Joint Owners of the interconnection facilities will be a contribution to capital under § 118(a).

Accordingly, based solely on the foregoing analysis and the representations made by Taxpayer and the Joint Owners, we rule that the transfer of the interconnection facilities by the Joint Owners 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 as to whether Taxpayer's representation that less than 2.5 percent of the total projected power flows over the interconnection facilities from Taxpayer to Facility is a reasonable projection for purposes of the five-percent test in Notice 88-129. In addition, no opinion is expressed or implied as to whether the member distribution cooperatives have the requisite benefits and burdens of ownership to the power prior to its transmission on the grid.

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,

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Office of Associate Chief Counsel
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Enclosure: 6110 copy

cc: